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# FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1983

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## HEARINGS

BEFORE THE

## COMMITTEE ON
## BANKING, HOUSING, AND URBAN AFFAIRS
## UNITED STATES SENATE

AND THE

## SUBCOMMITTEE ON ECONOMIC POLICY

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

OVERSIGHT ON THE MIDYEAR MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

AND

THE ISSUE OF MONETARY POLICY AND THE PROBLEMS THAT CAN CONFRONT IT GIVEN THE FEDERAL BUDGET AND THE CURRENT STATE OF THE ECONOMY

JULY 21 AND 28, 1983

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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# CONTENTS

## THURSDAY, JULY 21, 1983

Page

- Opening statement of Chairman Garn ..... 1
- Opening statements of:
  - Senator Lautenberg ..... 2
  - Senator Gorton ..... 3

## WITNESSES

- Paul A.Volcker, Chairman, Board of Governors, Federal Reserve System ..... 4
  - Questions on recovery over the long term ..... 5
  - Changes needed in monetary targets for 1984 ..... 6
  - Prepared statement ..... 9
    - The budgetary situation ..... 11
    - The international dimension ..... 13
    - Wage-price trends ..... 14
    - Monetary policy in 1983 and beyond ..... 16
    - Concluding remarks ..... 23
    - Appendix I ..... 24
    - Appendix II ..... 30
  - Midyear monetary policy report to Congress ..... 39
    - Section 1: The outlook for the economy ..... 40
    - Section 2: The Federal Reserve's objectives for growth of money and credit ..... 47
    - Section 3: The performance of the economy in the first half of 1983 ..... 51
    - Section 4: The growth of money and credit in the first half of 1983 ..... 66
  - Chrysler early payoff of Government loan ..... 76
  - How the IMF quota increase helps the United States ..... 77
  - Recent decline in $M_1$ velocity ..... 78
  - More restraint on Reserve positions ..... 81
  - Budget resolution and moratorium legislation ..... 82
  - Growth change between $M_1$ and the economy ..... 84
  - Danger ahead if deficit not cut ..... 86
  - Credit, wage demands, and prices ..... 88
  - Full employment and productivity still far off ..... 91
  - Publicity of $M_1$ and tax indexing ..... 93
  - Goal is for a moderate, sustained recovery ..... 96

## AFTERNOON SESSION

- Martin Feldstein, Chairman, Council of Economic Advisers ..... 99
  - Rising interest rates and inflation ..... 99
  - Money growth rate must be decreased ..... 102
  - Spending cuts and additional tax revenue ..... 104
  - New York Times story erroneous ..... 104
  - Moderate growth is safest policy ..... 106
  - Consequences if adjustments not made ..... 109
  - Depreciation of dollar and increased savings ..... 111
  - Congress and President must get proper fiscal mix ..... 112
  - Prepared statement ..... 115
- Beryl W. Sprinkel, Under Secretary for Monetary Affairs, Department of the Treasury ..... 134
  - How to get lower interest rates ..... 134
  - The relationship of money growth to velocity ..... 136

Beryl W. Sprinkel, Under Secretary for Monetary Affairs, Department of the Treasury—Continued Page
  Controlling the money supply 137
  FED needs gradual slowdown of money growth 139
  Prepared statement 141
  Treasury borrowing will absorb savings 160
  Must get better control of off-budget spending 165
Alan Blinder, professor of economics, Princeton University, Princeton, N.J 166
  Lowering the budget deficit 166
  Guides to monetary policy 168
  Prepared statement 172
Dr. A. James Meigs, senior vice president and chief economist, First Interstate Bank of California, Los Angeles, Calif 191
  Reduce growth of $M_1$ 191
  Importance of curbing money growth now 194
  Prepared statement 196
  Potential for shortrun tradeoffs 211
  Real and nominal interest rates 213
  Our present policy mix looks dangerous 216
  FED adjustments will slow recovery 218
  FED should keep inflation down; be cautious 220
  Must have some inflation to cut interest rates 222
  Adjustments in policy must be made now 223

## THURSDAY, JULY 28, 1983

Opening statement of Senator Gorton 225
Opening statement of Senator Heinz 299

## WITNESSES

Daniel Patrick Moynihan, United States Senator from the State of New York. 226
  Prepared statement 228
Paul A. Volcker, Chairman, Federal Reserve System Board of Governors 232
  Prepared statement 233
    The formulation of monetary policy 235
    The "Coordination" of fiscal and monetary policy 241
    Targeting the GNP 245
    Conclusion 246
    Federal Reserve press release—domestic policy directive—meeting held May 24, 1983 248
    Federal Reserve press release—domestic policy directive—meeting held May 28-29, 1983 264
    Appendix 283
  Coordination of fiscal and monetary policy 288
  FED has to make assumptions 290
  There is no easy solution to inflation 291
  Stabilization and intervention on value of dollar 293
  Estimates of effects of interest rates on exchange rates 295
  FED has taken cautious approach to changes 299
  Economic confidence in U.S. returns 301
  Congressional budget resolution is helpful 303
  Must maintain balance between interest and inflation 305

# FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1983

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THURSDAY, JULY 21, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, D.C.*

The committee met at 9:30 a.m., in room SD-538, of the Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Trible, Proxmire, Cranston, Riegle, Dodd, Dixon, Sasser, and Lautenberg.

## OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

At last week's confirmation hearing I announced that the committee vote would not be taken on the President's nomination of Paul Volcker for a second term as Chairman of the Federal Reserve System's Board of Governors until the completion of Mr. Volcker's testimony this morning. I delayed the vote because I believed the members of this committee should have the opportunity to question Chairman Volcker on prospective monetary policy before voting on his nomination.

Chairman Volcker was not at liberty last week to discuss the monetary growth targets adopted at the previous day's meetings of the Federal Open Market Committee. Those targets are of particular importance because of the recent behavior of the monetary aggregates since the fourth quarter of last year: M-$_1$ has been growing at an annual rate of about 14 percent, well above its target growth range of 4 to 8 percent.

On the other hand, growth in the other aggregates has been within their target ranges, near the upper boundaries of those ranges however.

In the real economy, it is clear that a strong economic expansion is underway. Recent upticks of interest rates are very worrisome to the committee.

Our objective is clear. We all want the maximum rate of economic growth that can be achieved without renewed inflation and another upsurge in interest rates. These qualifiers are necessary because if we let inflation and high interest rates return, our economic expansion will prove to be very short lived.

I believe that a key element in building the investor confidence that will be essential to a long-run economic expansion is to have a credible monetary policy. A credible monetary policy, in turn, requires credible targets for growth in the monetary aggregates. Failure to hit targets and frequent revisions in targets and/or in the definition of the targeted aggregates undermines the credibility of monetary policy.

This morning I hope we can help to build the needed credibility in monetary policy. At the end of Chairman Volcker's testimony, it is my intention to ask the committee to vote on his confirmation for a second term as Chairman of the Board of Governors of the Federal Reserve System. After that vote we will resume our hearing on monetary policy with Senator Gorton chairing the hearing.

Witnesses after Chairman Volcker will be addressing the issue of coordinating monetary policy and fiscal policy as well as the issue of the appropriateness of the Federal Reserve's current monetary policy.

Section 6 of the conference report on the first budget resolution for fiscal year 1984 requested the Banking Committee consider developing a Senate resolution on the coordination of monetary and fiscal policy. As a member of both the Banking Committee and the Budget Committee, as well as chairman of this committee's Economic Policy Subcommittee, Senator Gorton is taking the lead in evaluating the desirability of such a resolution and that is the purpose of his chairing the remainder of the hearings.

A subsequent hearing will also be held when Chairman Volcker will be asked to specifically address the coordination issue.

Mr. Chairman, before I turn to any of my colleagues, I can't resist stating publicly what I said to you privately as you came up. I just had breakfast with Arthur Burns. As he sat there chewing on his pipe, I tried to convince him that he should come over. I thought the photographers—with all the years they've spent taking pictures of your profile with the cigar and the years they spent in this committee with him and his pipe—would have a real photographic coup. If I could have gotten him to come over and the two of you to sit together, you with your cigar and him with his pipe, the photographers would have gone crazy. But I couldn't convince him to come over and do that. He was afraid we would start asking him questions as well and he wouldn't be released after the pictures. [Laughter.]

Senator Proxmire.

Senator **Proxmire**. I have no opening statement, Mr. Chairman. I would just say that your remarks are very useful because they indicate that the Fed for years has been operating behind a smokescreen. [Laughter.]

The **Chairman**. Are there any other of my colleagues who wish to make any opening statements before we turn to Chairman Volcker?

## OPENING STATEMENT OF SENATOR LAUTENBERG

Senator **Lautenberg**. I've got a brief one, Mr. Chairman, if I may, if no one else has. I promise not to quote the poet Proxmire today.

Mr. Chairman, I welcome our witnesses today. The decisions made on monetary policy over the next few months will have a major influence on the future of the economy and whether recovery will continue, how deep it will reach, whether it will grind to a halt.

To me, the causes of our economic problems are self-evident. They stem from a massive mismatch of fiscal and monetary policy which goes to the heart of the administration's program. It has proved impossible to finance the enormous increases in defense spending at the same time we are drastically cutting revenues even with the deep slashes in domestic programs.

The result of this policy has been a deficit to a size unimaginable only a few short years ago, not only for this year but projected out into the indefinite future and I quote here, "as far as the eye can see," in Mr. Stockman's words.

All discretionary domestic programs would have to be eliminated from the budget to come close to making up the $1 trillion debt President Reagan's program will have over the next 5 years.

I told Chairman Volcker last week that I thought the administration was putting him in an untenable position because of the posture taken on the budget. I am still of that opinion. It's unrealistic to expect the Fed to keep inflation in check with tight money without raising interest rates and choking off the recovery and it's good to have Chairman Volcker and the other as witnesses before this committee today. Each of them should address these questions.

I would submit that the budget resolution passed by the Congress is a responsible starting point for a bipartisan and effective policy for the economy.

I was unhappy to read in this morning's paper that we may be abandoning any attempt to increase the revenues. I think that would be disastrous. It will be painful to implement policies to reduce that deficit, but I think what we had represents the best compromise the Congress could devise to start getting the deficits down.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Lautenberg.

Senator Gorton.

## OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. Thank you, Mr. Chairman.

It would be pleasant one day to have the Chairman before us testify on a simple straightforward policy issue with relatively modest stakes. That does not seem to be in the cards. A salient feature of the economic environment which confronts the Chairman is the large Federal budget deficit and the demands which they will place on the Nation's credit markets.

Tuesday, Treasury Secretary Regan, in testimony before the Joint Economic Committee, offered the opinion that the current economic recovery and congressional spending restraint might be sufficient to eliminate the existing budget deficit or at least to reduce it to such levels that the Congress could forgo future tax increases. I hope that Secretary Regan is right, but I doubt it.

The structural deficit built into the Federal budget is very large, probably in the $100 billion range. In my view, this is too large to be acceptable. Reduction of the budget deficit is Congress job.

The Federal Reserve Board will have to deal with the problems that the large budget deficit causes. Treasury borrowing is creating great demands on the credit markets. To the extent that the Federal Reserve accommodates these credit demands by expanding the monetary supply more rapidly, it runs the risk of reigniting inflation.

On the other hand, a monetary policy which is too tight will increase interest rates unnecessarily damaging the vulnerable credit sensitive sectors of our economy.

Some increase in interest rates might be required not only to ration off existing savings but also to encourage more savings. Higher interest rates will also bring more foreign capital to our shores which, unfortunately, we need so much, but to the extent foreign capital inflows increase, the value of the dollar will be bid up, reducing our international competitiveness to serve in world markets.

Tradeoffs among these conflicting goals, significant in the best of time, is made more difficult by deficits of the magnitude which are experiencing now. Savings which would otherwise be used to finance productive investments, enriching our children, will instead be used to finance the Federal Government's expenditures. Most of these expenditures are current consumption rather than investment type activities, so not only does Federal borrowing threaten the current recovery by creating upward pressure on interest rates, it also reduces systematically the amount our society invests and, hence, reduces the size of the capital stock we pass on to our children.

Given the inability of Congress to agree on a budget which implies a more favorable fiscal policy, a disproportionate burden for trying to meet agreed upon national goals falls to monetary policy. Unfortunately, the Federal Reserve Board is limited in what it can do. The Federal Reserve must boil down all of these policy goals into a decision about essentially one magnitude—how much to expand the money supply.

Given an imperfect ability to control even this magnitude, as well as uncertainty about the ultimate effect of changes in the money supply on real economic activity, the task is an unenviable one.

The Senate Banking Committee is required under the first concurrent budget resolution to report by September a resolution expressing its sense of appropriate monetary policy. The report which the Federal Reserve Board provided yesterday deals essentially with this issue and I look forward to hearing your testimony, Chairman Volcker, as well as that of other distinguished witnesses representing Government, the financial industry, and academia.

The **Chairman**. Thank you.

Mr. Chairman, please proceed.

## STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. **Volcker**. Mr. Chairman, my statement bears a certain resemblance to a statement I delivered yesterday, and I won't read it in full. I might draw your attention to the fact that I attached a couple of appendices that deal with questions that have arisen here and elsewhere about definitions of money in relationship to the GNP and about the issue of targeting such variables as nominal GNP, real GNP, inflation, and the rest. I won't review that in detail, but note that that is attached to the statement.

So far as the statement itself is concerned, I will just summarize briefly by saying, as you indicated earlier, that we are in the midst of an economic recovery that I think has now attained a good deal of momentum in the short run, although there are still questions, of course, as to the strength and balance of that recovery as time is extended.

### QUESTIONS ON RECOVERY OVER THE LONG TERM

The fact that the economy is recovering rather rapidly now, I think, brings closer the day of concern about some other obstacles that have been apparent all along and that stand in the way of confidence that we can sustain this recovery over a long period of time consistent with the growth of productivity, the growth in income, and particularly the price stability that we need.

And I do emphasize in the statement that the budgetary problem that's been referred to here this morning and that we discussed last week is really the No. 1 obstacle to the kind of balance and sustainability that we want in the recovery.

One aspect of that I should bring out briefly: The pressures on financial markets that stem from the relatively large demand for funds augmented by the deficit have been a factor drawing into this country—it's the largest and richest country in the world—a large amount of capital from overseas. That may have some advantages in the short run, in that it does help finance the deficit directly or indirectly, but the only way we can draw capital from overseas on a net basis is by running a current account deficit, and under current circumstances that means a large and, in fact, growing trade deficit, which is a factor in the business situation. It is a distortion, in my mind, in the economy, and it is an adverse element in the business picture.

It raises questions about stability of the exchange rates and the international monetary system in the future. We have the immediate problem in the international area of the debt strains, the pressures, arising in so much of the developing world and particularly in Latin America. That problem, of course, has required an immense cooperative effort by debtors and creditors and governments and central banks around the world. It has been managed successfully in the sense that it is under control, but the problem has by no means gone away. It's not going to go away for a while, in my judgment.

Fundamentally, much depends upon growth in the industrialized world and particularly in the United States, and of course that problem would be greatly eased if we had a decline in interest rates over time; even shortrun increases in interest rates work against early solutions to that problem. It is a great complication and, I think, a threat to the American recovery and American financial markets if it's not managed successfully. In that connection, I believe the IMF legislation is going to come up in the

House—it's already passed the Senate, as you well know, and it seems to me terribly important that that legislation be passed.

The final point I make in the nature of questions or threats or obstacles, before getting to monetary policy in the statement is the question of whether the favorable price, wage, and productivity trends that we have seen in the past year will be sustained in an environment of growing business, higher profits, more employment, fewer layoffs, and a more buoyant atmosphere generally. There is still an understandable concern, a skepticism about the inflation outlook. There is a danger that both business and labor will revert to practices that became normal in the 1970's of anticipating inflation and moving aggressively to increase wages and prices. The irony would be, of course, that in the end that would threaten the increase in real wages and real profits and productivity that we need. That's a question that sometimes has raised the issue of incomes policies. They have not been very successful here or elsewhere, and I don't think that's a viable approach now, but I do think it's important that we keep our markets as open and competitive as we can, whether we talk about the external side or internal markets, and that is a continuing challenge because competition will be needed to keep that problem under control and create an environment in which aggresive wage and price setting will not undermine our hopes for a sustained recovery with price stability.

## CHANGES NEEDED IN MONETARY TARGETS FOR 1984

As far as monetary policy is concerned, that discussion begins on page 8 of my statement. I note that we have had some relationships between monetary growth and economic activity that have deviated from the trend of normal cyclical changes over earlier years for a variety of reasons. We have had some institutional changes. We have had an economic setting that I think has disturbed some of those relationships.

But if we look at this year, with the economy recovering rapidly, the broader monetary and credit aggregates that we have been emphasizing moved generally consistent with the ranges that we set in February.

As you know, the price trends were favorable during this period and in those circumstances the Federal Reserve had a rather accommodative approach with respect to bank reserves, and interest rates were broadly stable at the much lower levels to which they declined last year. But in the second quarter, and particularly as the second quarter proceeded, against a background of a considerable pickup in business activity, monetary and credit growth did show some tendency to increase more rapidly. Through this period $M_1$ growth has been particularly rapid, and I think more rapid than seemed consistent with long-term progress against inflation and orderly recovery.

Beginning in late May, the Open Market Committee has taken a slightly less accommodative posture toward the provision of bank reserves through open market operations, and borrowings by the banks at the discount window have increased. That action was taken with the fundamental view that whether we look at the domestic problem or whether we look at the international problem, limited, timely and potentially reversible measures now when the economy is expanding strongly, are clearly preferable to the risks of permitting a situation to develop that would require much more abrupt and forceful action later to deal with new inflationary pressures of a long sustained pattern of excessive monetary and credit growth.

We have had an increase in interest rates over this period of about 1 percent in terms of market rates. I would emphasize that apart from our actions and, increasing to a degree the pressure on bank reserves, we have had an increase in credit demands during this period. I emphasize that because we have had an increase in total credit demands, private and public, even though business credit demands during this period remained low or at the lower levels they reached earlier.

Of course, with the economy expanding rapidly, you would expect business credit demands to pick up sooner or later, too, and therein lies the threat to the future with Government credit financing being very well maintained, to put it euphemistically. With an increase in mortgage and consumer credit demands already showing, if you pile in some business credit demands on top of that, you've got potential problems in financial markets. That is one perspective in which to view the budgetary situation.

Looking ahead, we reaffirm the basic targets for $M_2$ and $M_3$ that we had set for this year and the target for total nonfinancial credit as well. I might mention, in that connection, that target, as we knew at the time, for total credit would permit credit expansion somewhat greater than the growth in GNP, and we thought that that was likely this year for a variety of reasons and tolerable, but I think it raises some question over a period of time whether credit growth at that rate of speed is compatible with progress both in the economy and on the inflation front. That's something that we're going to be wanting to review closely as we look ahead.

Tentatively, looking into 1984, the decision was to reduce all three of those targets, $M_2$, $M_3$ and credit, by one-half percent; we anticipate during that period that the growth of the economy would be less rapid than in the first year of economic recovery.

There have been questions raised about whether we can sustain the inflationary progress during that period. I think generally views within the Committee are more divided on that point. I think the anti-inflationary effort has a certain degree of momentum, but we are facing the test as to whether we can maintain that record during a period of recovery. It is a very critical test, and the limited reduction in those ranges tentatively set for next year are designed to give room for recovery, but consistent with containing the inflationary situation.

The $M_1$ targets have been a cause of considerably more debate. The decisions are more difficult. As you noted and as I noted, $M_1$ has been rising at a rapid rate of speed to date and a more rapid rate of speed than seems consistent with the inflationary situation—or the lack of inflation—that we would like to see.

We have examined that as carefully as we can and we do think there are reasons why the trend in $M_1$ may be changing and why the cyclical characteristics may be changing. They are importantly but not entirely tied up with the fact that we now pay interest on transactions balances to a considerable extent through NOW accounts. We have had nationwide NOW accounts for 2 or 3 years. We now have super NOW accounts which not only pay interest but pay a market rate of interest, and it is natural to believe that now that you can get interest on transactions balance holdings you will hold more transactions balances relative to other assets than was the case earlier. But even making allowance for those factors, I think it's clear that growth in $M_1$ has been larger than is likely to be consistent with progress on the inflation front. What we have essentially decided to do is look ahead from the point that we are at now, set a new target of 5 to 9 percent for the rest of this year, and look to a reduction of that by about 1 percent toward next year.

It's a rather wide range, purposefully so, because the bottom part of that range would be appropriate if velocity returns to more normal relationships and there are some signs that that process may be beginning. Something toward the higher area would be more appropriate if the growth in money was more in line with the nominal GNP rather than a rapid increase of velocity characteristic of past periods of recovery.

That is the basic outline of the targets that we are setting for next year. I would just conclude by saying that I think in the past 6 months or more we have made more rapid progress toward our economic objectives than we might have anticipated, but partly because of that rapid progress on the real side of growth in the economy I think the urgency of dealing with the obstacles that are clearly there to sustaining growth and stability have become even more pressing.

Those obstacles are very well known. What we need is a consensus on the specifics of how in a practical way to deal with them. I don't think there can be any assumption that monetary policy, however one conducts monetary policy, can substitute for such an important variable as budgetary discipline. It can't substitute for open competitive markets. We can't manufacture savings through monetary policy and we can't deal with structural financial weaknesses. All those problems have to be addressed.

There are lots of examples in other countries around the world of the dangers of procrastination and delay in the face of political impasse and in the hope the problems will subside by themselves. They seldom do, and if we don't act in time we face the possibility of shattered confidence, and once that is lost, you can only rebuild it with great difficulty over a period of time.

We are not in a state of crisis today, but there is certainly urgent areas where action is needed and needed very promptly. Thank you very much.

[The complete statement follows:]

## PREPARED STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I welcome this opportunity to discuss Federal Reserve monetary policy with the Banking Committee in the context of current and prospective economic conditions and other policies at home and abroad. You have before your the Midyear Monetary Policy Report to the Congress prepared in accordance with the Humphrey-Hawkins Act. This morning, I will highlight or expand upon some aspects of that Report. I am also attaching appendices discussing the role of the monetary aggregates and the appropriateness of the Federal Reserve setting and announcing objectives for a variety of economic variables, since questions in these areas have arisen in both the Senate and House Banking Committees.

We meet at a time when economic activity is plainly advancing at a rate of speed significantly faster than we, the Administration, the Congress, and most other observers thought likely at the start of the year. Over the past six or seven months of expansion, output has risen about as fast as in the average postwar recovery, more than 1 million more people are employed, and the unemployment rate has dropped by nearly a percentage point from its peak.

The very sizable gain in the Gross National Product during the second quarter in substantial part reflected a cessation of inventory liquidation — and perhaps small accumulations — by business. That is not unusual in the early stages of expansion, and does not necessarily suggest continuing gains at the same rate of speed. But it is also evident that domestic final sales and incomes are now increasing fairly rapidly, that the midyear tax cut has released further purchasing power, and that consumer and business confidence has improved. Consequently, strong forward momentum has carried into the third quarter, and potentially beyond.

The expansion so far has been accompanied by remarkably good price performance. Finished producer prices were essentially unchanged over the first half of 1983, and consumer prices were up at a rate of only 3 percent through May and by about 3-1/2 percent over the last twelve months. Perhaps more significant for the future, the rate of nominal wage increase -- at about a 4 percent annual rate -- is now at its lowest level since the mid-1960's, while average real wages, as in 1982, are rising. That pattern has been assisted by sizable productivity gains.

In all these respects, we are clearly "doing better." Yet, even as the economy has expanded and the inflation record has remained good, widespread forebodings remain evident for the future. Those concerns are understandable and justified so long as some major policy issues -- issues that I emphasized in my testimony to you earlier in the year -- remain unresolved. Indeed, the very speed and vigor of the recovery in its early stages has increased the urgency of facing up to those problems.

I have repeatedly expressed the view that we have come much of the way toward setting the stage for a long-sustained period of recovery, characterized by greater growth in productivity and real incomes and by much greater price stability. Responsible and prudent monetary policies must be one important element in making that vision a reality. But it would be an illusion to think that monetary policy alone can do the job, and before turning to monetary policy in detail, I want to touch again upon some crucially important aspects of the environment in which monetary policy must be conducted.

## The Budgetary Situation

I am aware of the enormous effort in the Congress over recent months to shape a responsible budgetary resolution -- indeed to preserve an orderly budgetary process. But the concrete results of that effort to date appear ambiguous at best, measured against the challenge of reducing the growing structural deficits embedded in the current budgetary outlook.

The current fiscal year is likely to see a budget deficit -- not counting Treasury or other market financing of off-budget credit programs -- of some $200 billion, or about 6-1/2 percent of the GNP. Forecasts of future years necessarily entail judgments about Congressional action yet to be taken as well as economic factors. Should Congress fail to implement the expenditure restraints as well as the revenue increases contemplated in the recent Budget Resolution -- and doubt has been expressed on that point within the Congress itself -- deficits appear likely to remain close to $200 billion for several years, even taking account of economic growth at the higher rates now projected. The hard fact remains that, as economic growth generates income and revenues to reduce the "cyclical" element in the deficit, the "underlying" or "structural" position of the budget will deteriorate without greater effort to reduce spending or increase revenues from that incorporated in existing programs. We would be left with the prospect that Federal financing would absorb through and beyond the mid-1980's a portion of our savings potential without precedent during a period of economic growth.

That outlook raises a fundamental question about the consistency of the budget outlook with the kind of economy we want. That is particularly the case with respect to such heavy users of credit as housing and business investment. To put the issue pointedly, the government will be financed, but others will be squeezed out in the process.

While that threat has been widely recognized, there has also been a comfortable assumption that the problem would not become urgent until 1985 or beyond. That might be true in the context of a rather slowly growing economy. But the speed of the current economic advance certainly brings the day of reckoning in financial markets earlier. In the second quarter, total nonfederal credit demands were already increasing substantially, even though business demands were essentially unchanged at a relatively low level. Potential credit market pressures have been ameloriated by a growing inflow of foreign capital,but a net capital inflow can be maintained only at the expense of a deep trade deficit. Banks have been sizable buyers of government securities during the early stages of recovery while business demands for credit have been relatively slack. But there has also been some tendency for overall measures of money, liquidity, and credit to rise recently at rates that, if long sustained, would be inconsistent with continuing or even consolidating progress toward price stability.

All of this, to my mind, points up the urgency of further action to reduce the budgetary deficit to make room for the credit needed to support growth in the private economy. Left unattended, the situation remains the most important single hazard to the sustained and balanced recovery we want.

## The International Dimension

The pressures on our capacity to finance both rising private credit demands and a huge budgetary deficit have, as I just noted, been one factor inducing a growing net capital inflow. One short-term consequence is lower domestic interest rates than might otherwise be necessary, and maintenance of extraordinary strength of the dollar at a time of rising trade and current account deficits. But the sustainability of those trends can be questioned. The picture of the largest and strongest economy in the world relying, in a capital-short world, on large inflows of funds to finance, directly or indirectly, internal budget deficits is not an inviting one for the future. The implication would be a persistently weak trade position, instability in the international financial system and exchange rates, and lack of balance in our recovery.

More immediately, the pressing debt problems of much of the developing world -- centered in, but not confined to, Latin America -- remain a clear threat to financial stability. In the period since we last discussed these issues, the strains have been successfully contained, but by no means resolved. To be sure, there are clear signs of progress with necessary economic adjustment in some instances -- notably in Mexico. Within the past week, Brazil -- which, along with Mexico, is the largest debtor -- has taken forceful and encouraging domestic actions that should provide a base for renewed IMF support and for added private financing. But "normalcy" has plainly not returned.

Confidence and market-oriented financing patterns cannot be fully restored without sustained growth among the industrialized countries, so that the debtors can earn their way with greater exports. Lower interest rates will be important as well. But that process will take time. Meanwhile, failure to provide the IMF -- which is the international institution at the center of the adjustment and financing process -- with adequate resources to do its job would deal a devastating blow to the extraordinary cooperative effort that has been marshaled to manage the situation, with potentially severe consequences for the U. S. financial system as well as the developing world. Early action by the House on the Administration's request in this matter is thus one key element in a program to sustain recovery.

## Wage-Price Trends

I touched earlier on the relatively favorable wage-price-productivity trends of the past year. We are now approaching a new test -- whether those trends can be extended into and through a period of recovery. Today, orders are rising, businesses are hiring, layoffs are sharply diminished, and profits are improving. After the inflationary experience of the 1970's, the temptation could arise to revert to what some might consider "normal" behavior -- to anticipate inflation, to return to wage increases characteristic of the earlier decade, to fatten profit margins as fast as possible by raising prices in a stronger market rather than relying on volume increases. But pressed collectively, the irony would be that such behavior, by inciting doubts about the inflationary outlook and affecting interest rates, would impair prospects for continued growth in real wages, in profits, and in employment.

We and other industrialized countries have had little success in dealing with that threat through so-called "incomes policies." But government policy can make a powerful contribution toward moderation through two avenues: first, by making evident in its fiscal and monetary management that inflationary pressures will continue to be contained, and second, by insisting upon open, competitive markets.

In that respect, open markets internationally serve our continuing basic interest in spurring efficiency and competition. Virtually every country has made compromises with protectionism during the period of recession. With growth underway, it is time not only to halt but to reverse that trend to help sustain expansion and the gains against inflation.

Moreover, as the economy grows stronger, I hope we will seriously turn more of our attention to the many purely domestic inhibitions to competition, and to reducing the artificial supports for prices and costs in some industries. All too often, they work at cross purposes to the needs of the economy as a whole.

## Monetary Policy in 1983 and Beyond

This setting of gratifying immediate progress, yet evident looming threats, has provided the environment for decisions with respect to monetary policy. As you are well aware, interest rates dropped sharply during the second half of 1982 as the recession continued, and, with inflation subsiding, reserve pressures on the banking system were relaxed. Growth in money and credit has been, quite plainly, adequate to support growth in economic activity -- indeed more growth in the first half of 1983 than had been generally anticipated.

During much of the period after mid-1982, institutional change, as well as adjustments by liquid asset holders to the sharp drop in interest rates, to declining inflation, and to the uncertainties of the recession, appeared to be affecting one or another of the monetary aggregates. In particular, the behavior of M1 in relation to economic activity and the nominal GNP has raised questions about whether the patterns in velocity established earlier in the postwar period might be changing, cyclically or on a trend basis. For that reason, less emphasis has been placed on that aggregate in policy implementation. For a time, the enthusiastic reception of the public to -- and aggressive marketing by depositary institutions of -- the new ceiling-free Money Market Deposit Accounts plainly affected growth in M2. Consequently, the target base for 1983 for that aggregate was set at the February and March average, rather than the fourth quarter of 1982, to avoid most of those distortions.

More broadly, given the questions about interpreting some of the monetary and credit aggregates, judgments as to the appropriate degree of pressure on bank reserve positions have been conditioned by available evidence about trends in economic and financial conditions, prices (including sensitive commodity prices), exchange rates, and other factors.

Through most of the first half of the year, as the economy picked up speed, the broader monetary and credit aggregates moved consistently with the ranges set in February. At the same time, trends in overall price indices were relatively favorable, and sensitive commodity prices, after an increase from cyclically depressed levels early in the year, appeared to be leveling off in the second quarter. The continuing exceptional strength of the dollar in foreign exchange markets and the international financial strains did not point in the direction of restraint. In all these circumstances, a broadly accommodative approach with respect to bank reserves appeared appropriate, despite much higher growth in M1 -- alone among the targeted aggregates -- than anticipated.

In the latter part of the second quarter, against the background of growing momentum in economic activity, monetary and credit growth showed some tendency to increase more rapidly, and M1 growth remained particularly high -- higher, if sustained, than seemed consistent with long-term progress against inflation and sustained orderly recovery. In these circumstances, the Federal Open Market Committee, beginning in late May, has taken a slightly less accommodative posture toward the provision of bank reserves through open market operations, leading to some increase in borrowings at the discount window. Whether viewed from a domestic or international perspective, limited, timely and potentially reversible measures now, when the economy is expanding strongly, are clearly preferable to the risks of permitting a situation to develop that would require much more abrupt and forceful action later to deal with new inflationary pressures and a long-sustained pattern of excessive monetary and credit growth.

These steps have been accompanied by increases, ranging from 3/4 to 1 percent or more,in both long-and short-term market interest rates. Apart from any monetary policy actions, these limited changes -- particularly in the intermediate and longer-term areas of the market -- appear also to have been influenced by larger private and government credit demands currently, as well as by expectations generated by stronger economic and monetary growth and the budgetary deficit.

Over the more distant future, balanced and sustained economic growth -- with strong housing and business investment --

would appear more likely to require lower rather than higher interest rates. That outcome, however, can be assured only if the progress against inflation can be consolidated and extended. In considering all these factors, the FOMC basically concluded that the prospects for sustained growth and for lower interest rates over time would be enhanced, rather than diminished, by modest and timely action to restrain excessive growth in money and liquidity, given its inflationary potential. But I must emphasize again that the best assurance we could have that monetary policy can in fact do its part by avoiding excessive monetary growth within a framework of a growing economy and reduced interest rates over time lies not in the tools of central banking alone, but in timely fiscal action.

Looking ahead, the Committee decided that the growth ranges established early in the year for M2 and M3 during 1983 (7-10 percent and 6½-9½ percent, respectively) are still appropriate. The most recent data, while showing somewhat larger increases in June, are still within (M2), or about at to the upper end (M3), of those ranges. (Charts and tables attached.)

As anticipated, the massive shifting of funds into M2 as a result of the introduction of Money Market Deposit Accounts, and to a more limited extent into Super NOW Accounts, has abated. We assume these new accounts, and the further deregulation of time deposit interest rates scheduled for October 1, will have little impact on growth trends in the period ahead. Given the reasonably favorable trend of prices, the ranges should be consistent with more real growth than thought probable at the start of the year.

The Committee also decided to continue the associated ranges for growth in total domestic non-financial credit of 8½ to 11½ percent. As you know, 1983 is the first time the Committee has set a range for a broad credit aggregate, and it is not given the same weight as the broader monetary aggregates, at least while we gain experience. We are aware that, consistent with the established range, growth in credit during 1983 could exceed nominal GNP, although the long-term trend is for practically no change in the ratio of credit to income (i.e., "credit velocity" is relatively flat). Somewhat faster growth in credit is consistent with experience so far this year, and may be related to the relatively rapid expansion in Federal debt.

For 1984, the Committee tentatively looks toward a reduction of 1/2 percent in each of those ranges, for M2, M3, and nonfinancial domestic credit. That small reduction appears appropriate and desirable, taking account of the need to sustain real growth while containing inflation. Those targets appear fully consistent, in the light of experience, with the economic projections of the Committee (as well as those of the Administration and those underlying the Budget Resolution).

The targets are, of course, subject to review around year end. One question that arises is whether the somewhat more rapid growth in credit than nominal GNP will, or should desirably, continue, consistent with progress toward price stability and toward a more conservative pattern of private finance than characteristic of the years of inflation. Again, the pressures on aggregate debt expansion stemming from the budgetary situation are a source of concern.

Decisions concerning appropriate targets for M1 were more difficult. As discussed further in Appendix I to this statement, the velocity of M1, whether measured as a contemporaneous or lagged relationship, has varied significantly from usual cyclical patterns, dropping more sharply and longer during the recession and failing to "snap back" as quickly. While a number of more temporary factors may have contributed, a significant part of the reason appears to be related to the fact that a major portion of the narrow "money supply" now pays interest, and the "spread" between the return available to individuals from holding M1 "money" and market rates has narrowed substantially, more than the decline in market rates itself implies. Put another way, NOW accounts, where the growth has been most rapid, are not only transaction balances, but now have a "savings" or "liquid asset" component. For a time at least, uncertainty about the financial and economic outlook, and less fear about inflation, may also have bolstered the desire to hold money.

Growth in M1 -- in running well above our targets for nine months -- has not, however, been confined to NOW accounts alone. Moreover, there are signs that the period of velocity decline may be ending. In looking ahead, with the economy expanding and with ample time for individuals and others to have adjusted to the rapid decline in interest rates last year, we must be alert to the possibility of a rebound in velocity along usual cyclical patterns, even though the longer-term trend may be changing.

In monitoring M1, the Committee felt that an appropriate approach would be to assess future growth from a base of the second quarter of 1983, looking toward growth close to, or below, nominal GNP. Specifically, the range was set at 5 to 9 percent for the remainder of this year, and at 1 percent lower -- 4-8 percent -- for 1984. Thus, the Committee, in the light of recent developments looks toward substantially slower, but not a reversal, of M1 growth in the future. Velocity is expected to increase, although not necessarily to the extent common in earlier recoveries.

The range specified is relatively wide, but depending on further evidence with respect to velocity, either the upper or lower portion of the range could be appropriate. As this implies, M1 will be monitored closely but will not be given full weight until a closer judgment can be made about its velocity characteristics for the future. We are, of course, aware that proposals to pay interest on demand deposits could, if enacted, influence velocity trends further over time.

These targets are designed to be consistent with continuing growth in economic activity and reduced unemployment in a framework of sustained progress against inflation -- and indeed are designed, insofar as monetary policy can, to contribute to those goals. The targets, by themselves, do not necessarily imply either further interest rate pressures or the reverse in the period ahead -- much will depend on other factors. In particular, progress in the budget and continued success in dealing with inflation should be powerful factors reducing the historically high level of interest rates over time, to the benefit of our private economy and the world at large.

## Concluding Remarks

In important ways, even more progress toward our continuing economic objectives has been made during the past six months than we anticipated. But it is also true -- partly because economic growth has increased -- that the need to deal, promptly and effectively, with the obstacles to sustained growth and stability have become more pressing. Those obstacles are well known to all of you. There is, indeed, little disagreement, conceptually, about their nature.

What has been lacking is a strong consensus about the specifics of how, in a practical way, to deal with them. There should be no assumption that monetary policy, however conducted, can itself substitute for budgetary discipline, for open and competitive markets, for inadequate savings, or for structural financial weaknesses.

The world economy offers ample illustration of the dangers of procrastination and delay in the face of political impasse, and in the hope that problems will subside by themselves -- only to be faced, in crisis circumstances, with the need for still stronger action in an atmosphere of shattered confidence. That great intangible of confidence, once lost, can only be rebuilt laboriously, step by step.

Here in the United States we have, with great effort, already gone a long way toward rebuilding the foundation for growth and stability. We are not today in crisis. The American economy -- for all its difficulties -- still stands as a beacon of strength and hope for all the world.

We know something of the risks and difficulties that could turn the outlook sour. But I also know that the actions necessary to make the vision of stability and sustained growth a reality are within our grasp. We have come too far, with too much effort, to fail to carry through now.

## APPENDIX I

Questions have been raised about the practicality of identifying a particular concept of money that has a stable relationship to broader economic objectives, such as economic activity, prices, and employment, and about the related issue of whether the recent "breakdown" in velocity behavior relative to historical norms is temporary or longer-lasting. Both these questions bear directly on the role of monetary aggregates in the formulation and implementation of monetary policy.

No single concept or definition of money or credit aggregates can reasonably be expected always to provide reliable signals about economic performance, or about the course of monetary policy and its relation to the nation's basic economic objectives of sustainable economic growth, high employment, and stable prices. One reason is that market innovations and regulatory changes can alter the significance of the various aggregates at different times. Usually, however, such changes take place gradually without basically altering relationships over the shorter-term. On occasion, their impact may be more sizable and abrupt, both in terms of influence on measured monetary aggregates and their relation to over-all economic performance. Definitions of the monetary aggregates can be, and have been, adapted to significant institutional changes, although all definitions of "money" necessarily involve at the margin a degree of arbitrariness. The various money and near-money assets often serve a variety of functions for their holders that cannot be precisely distinguished statistically.

Even in the absence of institutional changes in financial markets, changes in the public's desires to hold liquidity as compared with "normal" past patterns can, through impacts on velocity, alter growth rates in the aggregates that may be consistent with broader economic developments. These shifts in liquidity preference historically have occurred during periods characterized by unusual economic uncertainties associated with such developments as protracted economic weakness, fears of inflation, or instability in the financial system.

Consequently, the use of monetary and credit aggregates as guides for policy and in interpreting likely economic developments requires continuing judgment about the impact of emerging institutional developments and changing public preferences for money and credit demands, particularly when the economic or financial environment has changed drastically. In that context, the value of the aggregates for policy depends not so much on the "stability" of their relationships to other economic variables, but on the predictability of these relationships, taking into account structural shifts that are known to be in process. Monetary targeting is based on the presumption that structural changes will not be so rapid or so unpredictable as to undermine the usefulness of the aggregates as annual targets, although over time they may need to be adapted to ongoing behavioral changes.

For the past decade or so a series of institutional changes have affected the meaning and interpretation of the several monetary aggregates. Around the mid-1970s, various instruments and techniques began to be developed in financial markets that enabled depositors to economize on holdings of cash and to earn interest on highly liquid balances that to some extent substituted for cash. This new financial technology, abetted by legislative and regulatory changes that permitted depository institutions to compete more effectively, changed the shape of financial markets. The Federal Reserve adapted its definitions of monetary aggregates to the emerging institutional structure.

The narrowest definition of money--M1--was designed to measure transaction balances, and thus could be expected to bear a closer, more predictable relation to aggregate spending than the broader measures, which were affected as well by attitudes toward saving and wealth. The measure of M1 was redefined a few years ago in light of institutional changes to encompass transaction-type balances held in forms other than demand deposits. In particular, interest-bearing savings accounts subject to a regulatory ceiling rate but with checkable features (such as regular NOW accounts) were included in the measure, and later such accounts that could pay a market rate were also added (super-NOW accounts). However, these accounts served broader purposes for their holders than simply facilitating transactions. They also were an attractive repository for longer-term savings. Thus, interpretation of M1 was affected, and made less certain, especially over the past year or more, by its changing character; and the weight placed on this aggregate in policy implementation was necessarily altered during such periods of transition.

Over the last several quarters, the income velocity of M1 has fallen considerably and been much weaker than experience over comparable stages of post-war business cycles would have suggested, whether velocity is measured contemporaneously as the relationship of GNP to money in the current quarter or is measured on a lagged basis as the relationship of GNP to money one or two quarters earlier. This occurred as the share of NOW accounts in the aggregate expanded, as financial markets adjusted to lower rates of inflation, and as economic uncertainties were heightened during the recent period of economic contraction. The unusually large and sustained drop in M1 velocity may in the circumstances in large part reflect an enhanced demand for M1 that arose from the decline in inflation and the related sharp fall in market interest rates during the second half of 1982. The availability of interest-bearing NOW accounts may have made depositors even more willing to hold funds in M1-type accounts as market interest rates declined. In addition, M1 was probably boosted by heightened savings and precautionary demands. These savings demands originally manifested themselves in the contractionary phase of the current economic cycle, but apparently have to a degree continued into the expansion phase.

The "breakdown" in the pattern of the velocity of M1, in the sense of its unusual behavior during the current economic cycle, may well be abating. Its income velocity declined much less in the second quarter of this year than it had over the previous five quarters—which may suggest that velocity is beginning to move back toward a more familiar and predictable pattern of behavior. Of course, the radical change in composition of M1 over the past two and a half years—with interest-bearing NOW accounts (some subject to ceiling rates and some at market rates) presently representing about one-third of the deposits included in M1, a share that will probably grow—suggests that the pattern of M1 velocity, even after a transition period, may come to vary from what it had been in the past.

While the relatively short experience with an M1 measure that includes a prominent savings component (NOW accounts) tends to heighten uncertainty when predicting velocity behavior, it is by no means clear that our understanding of emerging velocity trends will be so limited as to preclude reasonable estimates of the outlook for velocity. Efforts to re-estimate money demand equations in light of recent institutional developments have helped explain a considerable part of recent velocity movements, and can be expected to be of assistance in projecting velocity.

Institutional changes have also affected the broader aggregates—M2 and M3—and they have been redefined as necessary to incorporate new instruments, such as money market funds, repurchase agreements, Eurodollars, and money market deposit accounts. With the definitional coverage of broad money measures enlarged, they encompass a very wide spectrum of liquid assets, so that these measures would tend to be less distorted than M1 by financial innovations and shifts of funds among various liquidity instruments. Very large shifts of funds, as were associated with the introduction of MMDAs, could distort particular money measures for a relatively short time, as was the case particularly for M2 in early 1983.

While the velocity of M2 departed from historical norms during the past several quarters, it did so to a lesser degree than M1. During the recent downturn M2 velocity declined only somewhat more than it had in past cyclical contractions on average. Thus far in the recovery phase of the cycle, the velocity of M2 has turned upward on average (after rough allowance for the distorting influence of shifts associated with the introduction of MMDAs) within the range of experience of previous cyclical expansions.

With regard to credit, institutional developments, the process of deregulation, and the emergence of innovative financing techniques in bond and other markets have contributed to reducing the special significance of bank credit as the cutting edge of changes in credit availability. As a result, more weight has been placed on a broad measure of total credit--in particular, the aggregate debt of domestic nonfinancial sectors--for helping to track credit needs as related to the overall economy and to guide monetary policy in that respect.

In brief, several money and credit measures taken as a group, together with an updating of definitions and measurement techniques as needed, can serve, and have served, as a useful guide for monetary policy, and in the light of a long sweep of history cannot be ignored. While it is true individual aggregates from time to time may be distorted by special developments and may not readily track the performance of the economy, the presumption remains of a longer-term stability and predictability in relationships.

## APPENDIX II

Questions have been raised about my views on the Federal Reserve's setting and announcing "objectives" for a variety of economic variables. As you know, the FOMC already reports its "projections" or "forecasts" for GNP, inflation, and unemployment. These projections are included with the materials I am reporting to the Committee today, as they have been at earlier hearings. I believe the practice of reporting the full range and the "central tendency" of FOMC members' expectations about the economy may be useful in reflecting the general direction of our thinking, as well as suggesting the range of possible outcomes for economic performance in the 12 or 18 months ahead, given our monetary policy decisions and fiscal and other developments over those periods.

There is a sense in which those projections reflect a view as to what outcome should be both feasible and acceptable -- given other policies and factors in the economy; otherwise monetary policy targets would presumably be changed. But I would point out that, like any other forecast, they are imperfect, and actual experience has sometimes been outside the forecast ranges.

Moreover, I believe there are strong reasons why it would be unwise to cite "objectives" for nominal or real GNP rather than "projections" or "assumptions" in these Reports.

The surface appeal of such a proposal is understandable. If a chosen path for GNP over a 6 to 18 month period could be achieved by monetary policy, specific objectives might appear to assist in debating and setting the appropriate course for monetary policy.

Unfortunately, the premise of that approach is not valid -- certainly not in the relatively short-run. The Federal Reserve alone cannot achieve within close limits a particular GNP objective -- real or nominal -- it or anyone else would choose. The fact of the matter is monetary policy is not the only force determining aggregate production and income. Large swings in the spending attitudes and behavior of businesses and consumers can affect overall income levels. Fiscal policy plays an important role in determining economic activity. Within the last decade, we also have seen the effects of supply-side shocks, such as from oil price increases, on aggregate levels of activity and prices. In the last six months, even without such shocks, the economy has deviated substantially from most forecasts, and from what might have been set as an objective for the year.

The response might well be "so what" -- it's still better to have something to "shoot at." But encouraging manipulation of the tools of monetary policy to achieve a specified short-run numerical goal could be counterproductive to the longer-term effort. Indeed, we do want a clear idea of what to "shoot at" over time -- sustained, non-inflationary growth. But the channels of influence from our actions -- the purchase or sale of securities in the market or a change in the discount rate -- to final spending totals are complex and indirect, and operate with lags, extending over years. The attempt to "fine tune" over, say, a six-month or yearly period, toward a numerically specific, but necessarily arbitrary, short-term objective could well defeat the longer-term purpose.

Equally dangerous would be any implicit assumption, in specifying an "objective" for GNP, that monetary policy is so powerful it could be relied upon to achieve that objective whatever else happens with respect to fiscal policy or otherwise. Such an impression would be no service to the Congress or to the public at large; at worst, it would work against the hard choices necessary on the budget and other matters, and ultimately undermine confidence in monetary policy itself.

Some of the difficulties could, in principle, be met by specifying numerical "objectives" over a longer period of time. But, experience strongly suggests that the focus will inevitably, in a charged political atmosphere, turn to the short-run. The ability of the monetary authorities to take a considered longer view -- which, after all, is a major part of the justification for a central bank insulated from partisan and passing political pressures -- would be threatened. Indeed, in the end, the pressures might be intense to set the short-run "objectives" directly in the political process, with some doubt that that result would give appropriate weight to the longer-run consequences of current policy decisions.

I would remind you that we have paid a high price for permitting inflation to accelerate and become embedded in our thinking and behavior, partly because we often thought we could "buy" a little more growth at the expense of a little inflation. The consequences only became apparent over time, and we do not want to repeat that mistake.

Put another way, decisions on monetary policy should take account of a variety of incoming information on GNP or its components, and give weight to the lagged implications of its actions beyond a short-term forecast horizon. This simply can't be incorporated into annual numerical objectives.

As a practical matter, I would despair of the ability of any Federal Reserve Chairman to obtain a meaningful agreement on a single numerical "objective" among 12 strong-willed members of the FOMC in the short run -- meaningful in the sense of being taken as the anchor for immediate policy decisions. Submerging differences in the outlook in a statistical average would, I fear, be substantially less meaningful than the present approach.

As you know, we adopted this year the approach of indicating the "central tendency" of Committee thinking as well as the full range of opinion. These "estimates" provide, it seems to me, a focus for debate and discussion about policy that, in the end, should be superior to an artificial process of "objective" setting that may obscure, rather than enlighten, the real dilemmas and choices.

Questions have also been raised on the issue of international coordination of monetary policy and whether or not to stabilize exchange rates multilaterally. I can deal with these important issues here only in a most summary way.

Coordination, in the broad sense of working together toward more price stability and sustained growth, is plainly desirable -- indeed it must be the foundation of greater exchange rate and international financial stability in the common interest. But stated so broadly, it is clearly a goal for economic policy as a whole, not just monetary policy.

The appropriate level of interest rates or monetary growth in any country are dependent in part on the posture of other policy instruments and economic conditions specific to that country. For that reason, explicit coordination, interpreted as trying to achieve a common level of, for instance, interest rates or money growth, may be neither practical nor desirable in specific circumstances. What does seem to me desirable -- and essential -- is that monetary (and other) policies here and abroad be conducted with full awareness of the policy posture, and possible reactions, of others, and the international consequences. In present circumstances, we work toward that objective by informal consultations in a variety of forums with our leading trade and financial partners, recently on some occasions with the presence of the Managing Director of the IMF.

As this may imply, I believe a greater degree of exchange market stability is clearly desirable, in the interest of our own economy, but that must rest on the foundation of internal stability. In recent years, in my judgment, the priority has clearly had to lie with measures to achieve that necessary internal stability. In specific situations, particular actions may appear to conflict with the desirability of exchange rate stability; that possibility is increased when the "mix" of fiscal and monetary policy is far from optimal, as I discussed earlier in my statement. Such "conflicts" should diminish as internal stability is more firmly established.

The idea of a more structured international system of exchange rates to enforce greater stability in the international monetary and trading system raises issues far beyond those I can deal with here. I do not believe it would be practical to move toward such a system at the present time, but neither would I dismiss such a possibility over time should we and others maintain progress toward the necessary domestic prerequisites.

Longer-run Ranges for Monetary and Credit Aggregates
Set by FOMC, 1983 and Tentative 1984
(Per cent increase, Q4 to Q4 unless otherwise noted)

| | Target Ranges | |
|---|---|---|
| | 1983 | 1984 |
| M2 | 7 to 10[1] | 6-1/2 to 9-1/2 |
| M3 | 6-1/2 to 9-1/2 | 6 to 9 |
| | **Monitoring Ranges** | |
| | 1983 | 1984 |
| M1 | 5 to 9[2] | 4 to 8 |
| Total credit[3] | 8-1/2 to 11-1/2 | 8 to 11 |

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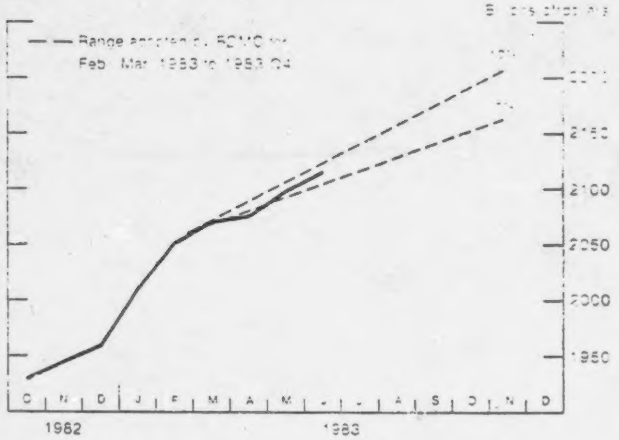
1. February-March 1983 average taken as base.
2. Q2 1983 taken as base.
3. Represents growth in domestic nonfinancial sector debt between yearends.

Economic Projections for 1983 and 1984

| | FOMC Members | | Administration |
|---|---|---|---|
| | Range | Central Tendency | |
| 1983 | | | |
| Percent change, fourth quarter to fourth quarter: | | | |
| Nominal GNP | 9-1/4 to 10-3/4 | 9-3/4 to 10 | 10.4 |
| Real GNP | 4-3/4 to 6 | 5 to 5-3/4 | 5.5 |
| Implicit deflator for GNP | 4 to 5-1/4 | 4-1/4 to 4-3/4 | 4.6 |
| Average level in the fourth quarter, percent: | | | |
| Unemployment rate | 9 to 9-3/4 | About 9-1/2 | 9.6 |
| 1984 | | | |
| Percent change, fourth quarter to fourth quarter: | | | |
| Nominal GNP | 7 to 10-1/4 | 9 to 10 | 9.7 |
| Real GNP | 3 to 5 | 4 to 4-1/2 | 4.5 |
| Implicit deflator for GNP | 3-3/4 to 6-1/2 | 4-1/4 to 5 | 5.0 |
| Average level in the fourth quarter, percent: | | | |
| Unemployment rate | 8-1/4 to 9-1/4 | 8-1/4 to 8-3/4 | 8.6 |

## Ranges and Actual Money Growth

M2

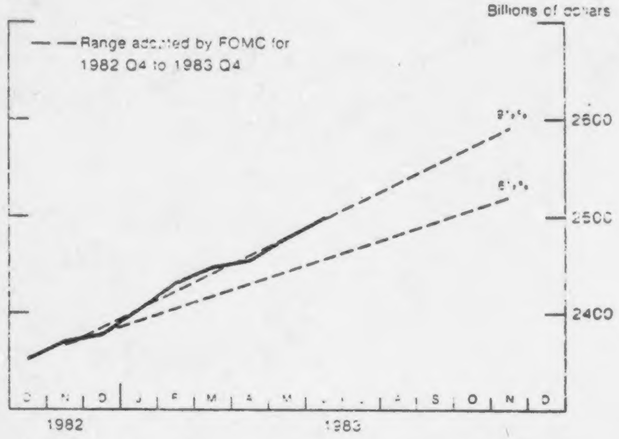


Rates of Growth
(annual rate)

Feb.–Mar. 1983 to 1983 Q2
8.2 percent

Feb.–Mar. 1983 to June 1983
9.1 percent

M3



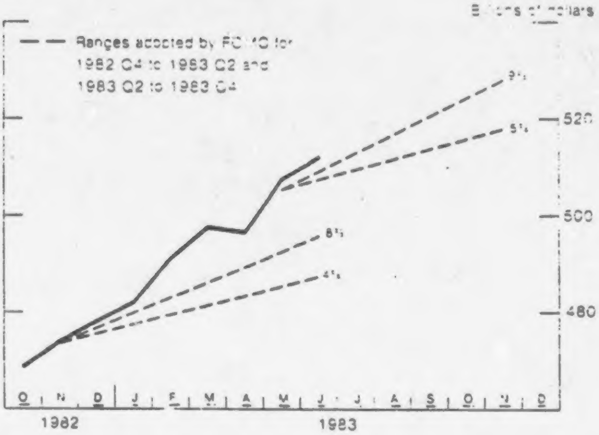
Rates of Growth
(annual rate)

1982 Q4 to 1983 Q2
9.3 percent

1982 Q4 to June 1983
9.6 percent

## Ranges and Actual Money and Credit Growth

### M1

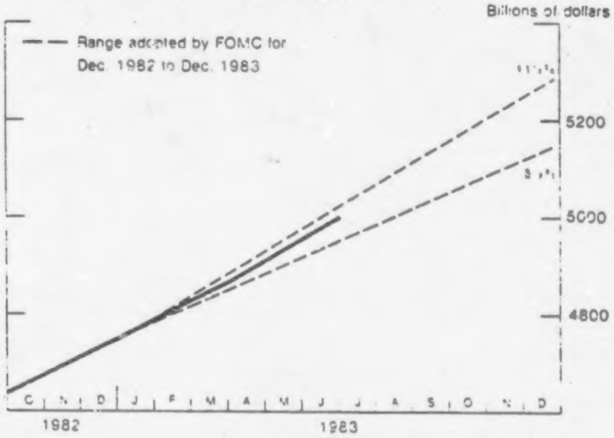


Rates of Growth
(annual rate)

1982 Q4 to 1983 Q2
13.4 percent

1982 Q4 to June 1983
13.9 percent

### Total Domestic Nonfinancial Sector Debt



Rate of Growth
(annual rate)

Dec. 1982 to June 1983
10.6 percent

**Board of Governors of the Federal Reserve System**

# Midyear Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

July 20, 1983

## Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 20, 1983

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

## Section 1: The Outlook for the Economy

When the year began, an economic expansion was under way, but it was widely expected that the recovery, at least in its initial phases, would be significantly less rapid than the average postwar cyclical upswing. The economic recessions of the early 1980s and more moderate than anticipated inflation had exposed serious financial strains both at home and abroad--strains that in part grew out of practices that developed during years of inflation. Consumer confidence was still at a low ebb, and a high degree of caution was apparent in the business community. Interest rates, despite having declined substantially, were still at levels that appeared likely to inhibit strong growth of activity in interest-sensitive sectors, and a weak demand for U.S. exports was expected to damp the pace of economic expansion.

By the second quarter, however, the recovery had gained vigor, and was following in most respects a typical cyclical pattern. Advances in residential construction were exceptionally large during the first half, and there were sustained increases in consumer spending, particularly for durable goods. Businesses continued to liquidate inventories at a rapid pace through the first quarter, but then apparently began rebuilding stocks in the second quarter as final demands strengthened. Employment gains became substantial as the recovery gathered speed, and the unemployment rate in June--while still high historically--was three-quarters of a percent below the earlier peak.

Given the momentum of the recovery--and the added stimulus of another reduction in personal taxes at midyear--there is a strong likelihood that real GNP will continue growing at a healthy pace through the second half of 1983. Gains in employment have generated sizable increases in income, which in turn are laying the groundwork for further advances in consumer spending. And, business spending on equipment appears to be turning up. The cumulative forces of economic expansion thus appear to be well established.

Real GNP growth in the second half as a whole may not match the rapid second-quarter pace, which partly reflected the sharp swing in inventory positions. In addition, given the level of housing starts reached in the second quarter, and with mortgage interest rates no longer falling, outlays for residential construction seem unlikely to continue rising at the extraordinary pace of early 1983. Business spending for structures may still be sluggish in the second half, particularly with office space in ample supply in most cities. The foreign sector, too, will be exerting a restraining influence on growth of output in the United States, owing to a strong dollar, relatively slow growth in the other industrial nations, and financial difficulties besetting many developing countries.

Employment is likely to continue expanding as the recovery in output progresses, with gradual declines in the unemployment rate. However, if past experience is any guide, the strengthening economy will itself prompt more job-seekers to enter the labor force, thereby reinforcing the inertia of the unemployment rate. Consequently, unemployment will remain high, relative to the earlier postwar period, for some time.

The near-term outlook for inflation continues to be reasonably favorable. Wage pressures have moderated further into 1983; productivity is improving; and the continued strength of the dollar is limiting increases in the prices of imported goods. A partial rebound in energy prices during the early spring, following the pronounced weakness earlier in the year, already appeared to be abating by midyear. A spurt in some food prices resulting from bad weather does not appear to be cumulating into a major price advance. Given these considerations, as well as the favorable first-half price performance, the chances appear excellent that inflation rates for 1983 as a whole will be as low as, or even lower than, those of 1982.

At the same time that the general trend of price increase is still slowing, there are indications that some of the cyclical influences that helped reduce inflation during the recession have waned. With demands for goods and services strengthening, price discounting is diminishing; and the downward pressures on prices and wages in some markets will lessen as orders and labor demand rise. Such developments are to some extent inevitable. What is of critical importance is that these cyclical influences not impair more lasting progress toward reduction in the underlying rate of inflation, as reflected in the interactions of wages, productivity, and costs.

Recently, the concerns on that score have been heightened somewhat by several factors. Preliminary indications are that growth in nominal GNP approached 11 percent in the second quarter. That high rate of spending growth is a welcome development insofar as it has come about in the context of accelerated real output growth and moderating prices. However, growth in some measures of money and credit also have been relatively large recently, and growth in nominal spending at the present rate over a sustained period would suggest renewed inflationary pressures.

The vigor of the private economy at midyear also has underscored the potential problems associated with federal budget deficits that will remain massive in the years ahead, unless there are decisive actions to reduce expenditures or--absent such action--to increase revenues. Prospects for interest rates are related to a number of factors, including importantly the actual and perceived trend in inflation. In 1982, when the economy was mired in recession and the inflation rate was falling, record-large government deficits were consistent with declining interest rates. However, should public credit demands remain at or near record highs while private credit demands are expanding rapidly in response to rising business activity, the outlook for interest rates would clearly be affected.

The difficulties of controlling federal deficits are evident in the legislative developments of recent months, during which there have been extensive and laborious efforts to arrive at a workable budget resolution. These difficulties notwithstanding, unless there is further progress in reducing deficits, the risk of strains in credit markets intensifying is apparent, impairing the prospects for a balanced economic recovery.

## FOMC Members' Economic Projections

Members of the Federal Open Market Committee believe that the current economic recovery will be well maintained over the remainder of 1983 and on through 1984. The central tendency of forecasts of the FOMC members show this year's growth in real GNP falling in a range of between 5 and 5-3/4 percent--a significantly stronger rate of growth than in the projections previously submitted to Congress in the Monetary Policy Report of last February. Real growth in 1984 is expected to be about one percent slower than in 1983, and the unemployment rate is projected to trend lower through the end of next year.

Most FOMC members expect this year's increase in the GNP implicit price deflator to range between 4-1/4 percent and 4-3/4 percent--about the same as last year's increase and in line with the projections of the February Monetary Policy Report. There is less consensus about the inflation outlook for 1984, with some concerned that inflation is likely to accelerate. However, most FOMC members feel that, with appropriate policies, prices overall are likely to rise in the same range as, or only a shade more rapidly than, in

Economic Projections for 1983 and 1984

| | FOMC Members | | Administration |
|---|---|---|---|
| | Range | Central Tendency | |
| 1983 | | | |
| Percent change, fourth quarter to fourth quarter: | | | |
| Nominal GNP | 9-1/4 to 10-3/4 | 9-3/4 to 10 | 10.4 |
| Real GNP | 4-3/4 to 6 | 5 to 5-3/4 | 5.5 |
| Implicit deflator for GNP | 4 to 5-1/4 | 4-1/4 to 4-3/4 | 4.6 |
| Average level in the fourth quarter, percent: | | | |
| Unemployment rate | 9 to 9-3/4 | About 9-1/2 | 9.6 |
| 1984 | | | |
| Percent change, fourth quarter to fourth quarter: | | | |
| Nominal GNP | 7 to 10-1/4 | 9 to 10 | 9.7 |
| Real GNP | 3 to 5 | 4 to 4-1/2 | 4.5 |
| Implicit deflator for GNP | 3-3/4 to 6-1/2 | 4-1/4 to 5 | 5.0 |
| Average level in the fourth quarter, percent: | | | |
| Unemployment rate | 8-1/4 to 9-1/4 | 8-1/4 to 8-3/4 | 8.6 |

1983. The cyclical strengthening of demand associated with the recovery is one factor in this inflation projection, but price developments next year will also reflect a number of special factors, such as policies to reduce farm product supplies and raise farm incomes, cost pressures from increased payroll taxes, and the possibility of some weakening in the foreign exchange value of the dollar.

The central tendency projections of the FOMC members, for prices as well as for real GNP and unemployment, are closely in line with the economic assumptions prepared by the Administration for its mid-session review of the budget.

While most FOMC members are relatively optimistic about the prospects for maintaining economic growth and containing inflation over the next year and a half, they also are mindful of potential difficulties that could disrupt the outlook and cause the nation's economic performance to be less favorable than is now expected. There is, as already noted, the prospect that federal budget deficits will remain extremely large into the indefinite future; as the private recovery lengthens, the dangers associated with those deficits are likely to increase, posing a threat to both the inflation outlook and the sustainability of a balanced expansion.

There also are some broader risks, not specifically related to the budget, that some of the progress against inflation could be reversed as the private economy strengthens. The persistence of inflationary expectations is evident both in recent surveys of private opinion and in the behavior of financial markets, in which borrowers remain willing to pay high nominal rates of return on long-term debt instruments. As the recovery progresses, wage and price developments will need to be monitored with great care to make sure that these still-present expectations of inflation are not undergirding a new round of acceleration in actual wage and price increases.

More generally, the United States has become much more integrated into the world economy than it was a decade ago, and our economic fortunes have become closely linked with those of other nations. Because of those close linkages, the economic difficulties of many foreign nations, particularly the serious financial problems still plaguing many developing countries, could affect this nation's economic performance in the period ahead.

To some extent, these risks in the economic outlook can be moderated by appropriate policies. For example, the risk of a further deterioration in the economic prospects facing the developing nations can be lessened if lenders, borrowers, national authorities, and international organizations maintain the high degree of cooperation that has become evident in the past year. Prompt action by the United States to bolster the resources of the International Monetary Fund and of the multilateral development banks is an essential element in managing successfully a difficult adjustment process.

This country's budgetary problems also are manageable, provided the Congress and the Administration take action. The Federal Reserve, for its part, remains committed to monetary policies that will provide enough money and credit to support economic growth in a context of containing inflation; without reductions in future fiscal deficits, the goal of maintaining a balanced recovery while at the same time holding down inflation could prove elusive.

## Section 2: The Federal Reserve's Objectives for Growth of Money and Credit

The Committee reviewed its target ranges for 1983 and established tentative ranges for 1984 in light of its basic objectives of encouraging sustained economic recovery while continuing to make progress toward stability in the average level of prices. In setting these ranges, the Committee recognized that the relationships among the money and credit aggregates and economic activity in the period ahead are subject to considerable uncertainty; consequently, it was emphasized that, in implementing policy, the significance to be attached to movements in the various aggregates would depend on evidence about the strength of economic recovery, the outlook for prices and inflationary expectations, and emerging conditions in domestic and international financial markets.

With respect to the ranges for the broader monetary aggregates--M2 and M3--the Committee reaffirmed the 1983 ranges of 7 to 10 percent and 6-1/2 to 9-1/2 percent, respectively, that had been established earlier in the year. The tentative ranges for next year set for these aggregates were reduced one-half percentage point to 6-1/2 to 9-1/2 percent and 6 to 9 percent, respectively, as measured in both cases from the fourth quarter of 1983 to the fourth quarter of 1984.

It was expected, in setting these tentative ranges, that shifts into money market deposit accounts (MMDAs) would not significantly distort growth in the broader aggregates, particularly M2, in contrast to the experience in the early part of this year. (A discussion of this and other monetary developments earlier this year can be found in Section 4.) However, it was also recognized that the greater flexibility in liability management for banks and thrift institutions resulting from the availability of MMDAs, together with the recent decision of the Depository Institutions Deregulation Committee to eliminate ceiling rates on time deposits [1] by October 1 of this year, would be a factor encouraging somewhat more rapid growth in M2 relative to M3, as banks and thrifts may rely relatively less on large CDs and other money market liabilities in funding credit expansion. With greater growth in real (and nominal) GNP than anticipated earlier--but in the context of moderating inflation--actual growth in M2 and M3 may reasonably be higher in the ranges than thought likely earlier.

The FOMC also agreed that principal weight would continue to be placed on the broader monetary aggregates in the implementation of monetary policy, in view of the continuing uncertainties that attach to the behavior and trend of M1 over time. As discussed in Section 4, an unusual, sizable decline in the velocity of M1 has been experienced over the past several quarters, likely reflecting in part the fact that interest-bearing NOW accounts have become an important component of M1. These accounts, which have both savings and transactions characteristics, appear to have increased the response of M1 demand to changes in market interest rates, which may explain a good part of the acceleration of M1 growth beginning last summer. Also, particularly in the course of 1982, demand for M1 may have been increased because savers sought to hold funds in highly liquid forms in light of various economic and financial uncertainties.

Recent evidence suggests that the decline in the velocity of M1 may be abating. The income velocity of M1 evidently declined only modestly in the

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1. Except for accounts less than $2,500 maturing in 31 days or less.

second quarter of this year. With the upward impact on M1 demand of earlier interest rate declines having faded, and given the sizable build-up in liquid balances that has taken place, it seems probable that some pick-up in the velocity of M1 will develop over the quarters ahead, in closer conformance with cyclical and secular patterns of earlier years.

Whether any rise in velocity would be as strong as in earlier decades of the post-World II period remains uncertain. Experience to date with a measure of M1 that reflects to a greater extent the savings propensities of the public, as well as transactions demands, has been relatively limited, which makes it difficult to assess its behavior under varying economic circumstances. Moreover, it is not clear how responsive M1 demand will be to market interest rates over the period ahead if Super NOW accounts, which yield a market return to holders, become a more important element in the aggregate. (If the authority to pay interest on transactions balances were extended beyond currently eligible accounts, this too would affect M1 behavior, presumably in the short run increasing the demand for the aggregate, but no specific allowance has been made for that possibility.)

Taking account of these various uncertainties, for the purpose of monitoring M1 behavior, the Committee established a growth range of 5 to 9 percent (annual rate) for the period from the second quarter to the fourth quarter of this year. The decision to establish a new base for monitoring M1 reflected a judgment that the rapid growth over the past several quarters should be treated as a one-time phenonemon, neither to be retraced or long extended. A monitoring range of 4 to 8 percent was tentatively established for the period from the fourth quarter of 1983 to the fourth quarter of 1984.

These ranges anticipate no further decline in the velocity of M1 during a period of relatively strong growth in economic activity and allow for the likelihood of some rebound in velocity. M1 growth would be expected to move lower in these ranges as and if velocity strengthens.

The Committee reaffirmed the range of 8-1/2 to 11-1/2 percent used for monitoring the behavior of domestic nonfinancial sector debt in 1983. That range was reduced to 8 to 11 percent for 1984. The federal government next year is expected to continue absorbing an unusually large share of overall credit supplies. The Committee's range would encompass the possibility of growth of total debt in excess of likely GNP growth (and the long-term trend of credit in relation to GNP) in light of the analysis of various factors bearing on credit growth. Nevertheless, the prospect of intensifying conflict between sustained large government requirements and growing private sector credit demands is a serious concern.

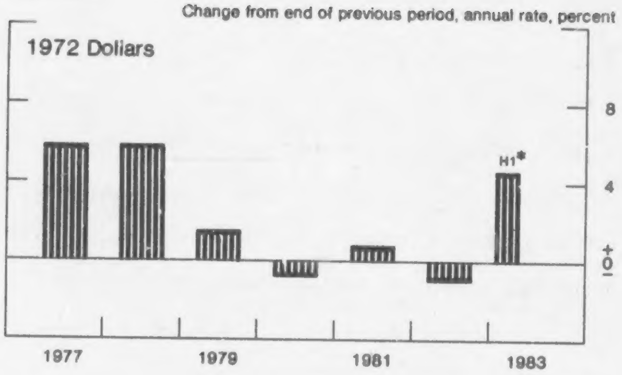
## Section 3: The Performance of the Economy in the First Half of 1983

The economic expansion that began at the end of 1982 gathered momentum over the first half of 1983. After increasing moderately in the first quarter, real gross national product registered a strong advance in the second quarter, as production and employment rose in a broad range of industries. An apparent completion of the recession-induced inventory liquidation accounted for much of the second-quarter growth; but domestic final sales also strengthened considerably, and forward-looking indicators point to further output gains in the months ahead.

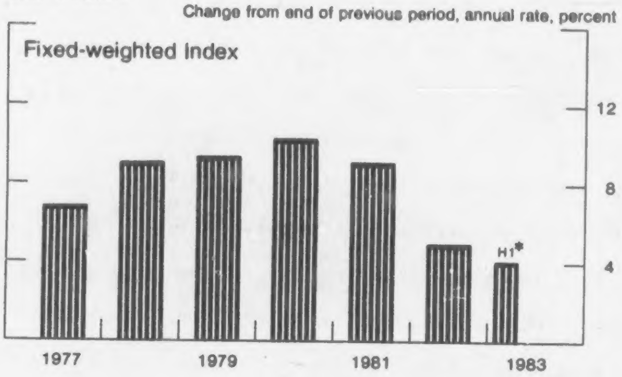
To be sure, a number of serious economic problems remain. The economic recovery is far from complete. At midyear, 10 percent of the civilian labor force was still unemployed. Many companies continue to face major adjustments in an effort to stay competitive in their industries here and abroad. Some domestic energy producers remain in financial difficulty, as do many producers in the agricultural sector. The nation's external sector continues to be a weak link in the recovery, as exports are being limited by a strong dollar, the sluggishness of a number of other industrialized economies and the severe adjustment problems of much of Latin America; the international indebtedness and related economic difficulties of a number of developing countries remain a matter of particular concern.

This country's period of moderating inflation lengthened in the first half of 1983. In 1982, many price measures recorded the smallest increases in a decade, and price developments so far this year have been even more favorable. Transitory elements clearly have played a part in

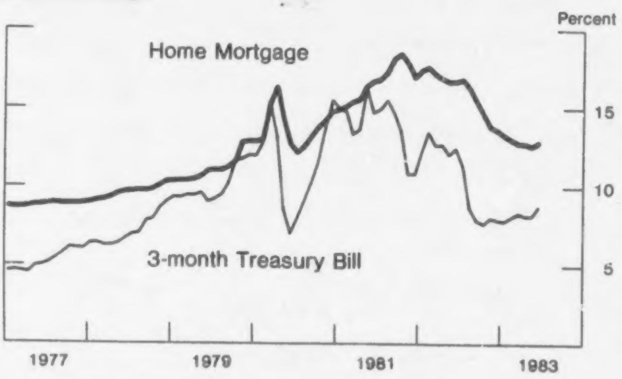
**Real GNP**



**GNP Prices**



**Interest Rates**



* Data for 1983 H1 are based partly on advance projections from the Commerce Department

this improving price performance, but there also continue to be indications of more lasting progress. In particular, productivity has been improving and increases in compensation continue to moderate, so that the interactions between costs and prices, which imparted a stubborn momentum to inflation through the 1970s, are still working to reduce the underlying or trend rate of inflation.

However, even though prices have slowed dramatically, concerns persist that inflation will reaccelerate as the recovery progresses. To a considerable extent, these concerns arise from the experience of past business cycles and from an expectation that the federal government's budget deficits will remain massive in the years ahead, making more difficult the sustained application of a noninflationary monetary policy. Because of such concerns about the future, as well as the present high level of actual government borrowing, short- and long-term interest rates in the first half of 1983 continued to be quite high, relative both to historical experience and to the current pace of inflation.

As had been true during the recession, government debt rose very rapidly in the first half of 1983; in addition, household borrowing picked up as the expansion accelerated. Even though the growth in business borrowing remained relatively low, total debt outstanding in the domestic nonfinancial sectors grew at an annual rate of about 10-1/2 percent--a faster pace than in 1982. Debt grew faster in the second quarter than in the first.

Money holdings also increased rapidly in the first half of 1983, as a strengthening of private spending bolstered the demand for transactions balances and as lower interest rates led many individuals and businesses to hold a larger portion of their financial assets in the form of money balances. In addition, money growth also was affected by portfolio shifts arising from the progressive liberalization of deposit rate regulations; these shifts were especially important in boosting growth of the broader monetary aggregates early in the year.

## Interest rates

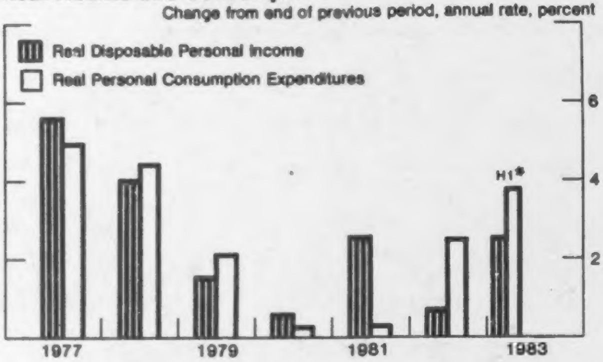
Short-term interest rates had fallen sharply in the second half of 1982, when the recession was deepening; and by the end of last year, rates were only about half the peak levels of 1981. Yields then fluctuated in a relatively narrow range through most of the first half of 1983, before moving a little higher around midyear as the recovery strengthened. At midyear, short-term yields were generally 50 to 125 basis points above their December levels; the Federal Reserve discount rate remained unchanged over the first half of the year.

Long-term rates eased further into early 1983, extending the decline that began in mid-1982. The further reduction in long-term yields resulted from beliefs that the recovery might be relatively weak, thereby limiting private credit needs and, at the same time, enhancing the prospects for a continued moderation of price inflation. In the second quarter, however, long-term rates turned up slightly as economic activity strengthened further and as market participants began to focus more directly on the potential effects of heavy federal borrowing and the implications of continued rapid money growth.

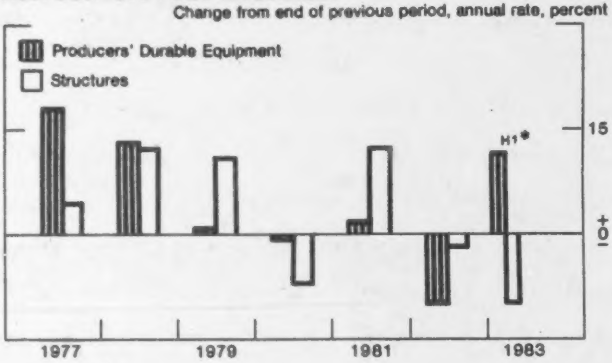
## Consumer Spending

Much of the vigor of the current expansion has arisen from increases in income and spending in the household sector. Throughout the recession,

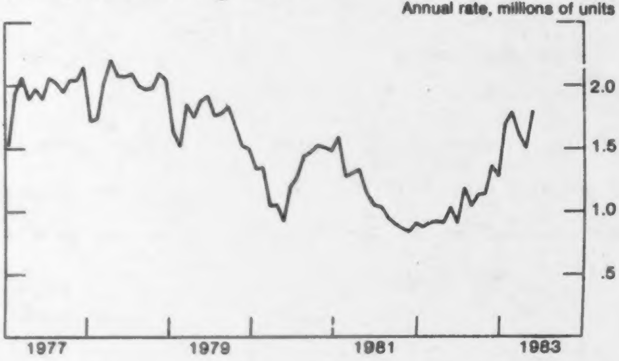
### Real Income and Consumption



### Real Business Fixed Investment



### Total Private Housing Starts



* Data for 1983 H1 are based partly on advance projections from the Commerce Department.

the nominal disposable incomes of consumers had been unusually well maintained by a combination of countercyclical transfer payments, rising interest income, and reductions in tax rates. A rapid decline in inflation enhanced the purchasing power of these nominal income gains, and by the end of 1982, real disposable personal income was about 2 percent above its prerecession level of mid-1981.

Households have strengthened their balance sheets considerably in recent years by acquiring large amounts of liquid assets and holding down the accumulation of new indebtedness. In addition, a sharp, sustained rise in stock prices added considerably to household wealth after mid-1982. Thus, when aggregate wage and salary income began rising with the upturn in activity, consumers were well positioned to boost spending on goods and services.

After a period of sluggish growth through most of 1982, consumer spending improved toward the end of last year and strengthened further in the first half of 1983. Second-quarter spending, in particular, was quite vigorous, as purchases of autos and other big-ticket items increased markedly. Sales of domestic autos were at an annual rate of about 6-3/4 million units in the second quarter, the best quarterly sales pace since mid-1981; sales of foreign models were maintained at a rate of about 2-1/4 million units.

With income growth accelerating, economic prospects brightening, and interest rates lower than in 1982, consumers became more willing to take on new debt in the first half of 1983. In addition, lenders showed a greater interest in making consumer loans, partly--in the case of depository institutions--as an outlet for investing the large inflows to new accounts. Thus, after rising only 4 percent in 1982, installment debt rose at more than a

7 percent annual rate in the first quarter, and still faster growth appears to have occurred in the second quarter.

## Business Spending

Economic conditions in the business sector also have improved. Reduced interest rates, the elimination of unwanted inventories, and an expanding economy have relieved some of the financial strains brought on by the recession and, at the same time, have created a better climate for investment spending. Business cash flows improved in the first half, as profit margins widened considerably. Buoyed by rising investor confidence, stock prices rose to new highs, enabling businesses to rely heavily on equity financing while limiting the growth in indebtedness. In addition, encouraged by bond yields that were well below earlier peaks, firms strengthened their balance sheets by shifting their borrowing toward longer-term maturities. These general trends notwithstanding, many firms that were weakened by the recession continued to face financial difficulties in the first half of 1983, and the number of business bankruptcies--though declining--remained high.

Business investment spending, which fell nearly 8 percent in real terms during the recession, turned up in the first half of 1983, as real outlays for equipment rose in both the first and second quarters. In contrast to equipment, spending for structures fell appreciably during the first half of 1983, led by reduced outlays for commercial and industrial buildings. With office and industrial vacancy rates now quite high, it may be some time before the expanding economy begins to generate a sustained increase in outlays for these types of facilities.

Businesses had liquidated inventories at a rapid pace during the recession in an effort to bring stocks more in line with the recession-reduced sales levels, and the momentum of that liquidation carried into early 1983. More recently, with final sales continuing to rise, businesses appear to have begun a cautious rebuilding of stocks. In the second quarter, a move from sizable inventory liquidation to an apparent small accumulation of stocks provided a strong impetus for increased production, resulting in a rise in second-quarter GNP much larger than the advance in final sales.

## Residential construction

Responding to lower interest rates, activity in the housing sector rose sharply in late 1982 and increased further in the first half of this year. At the end of last year, mortgage rates were about 5 percentage points below the peak rates reached in the fall of 1981, and they continued to trend gradually lower before firming in the past two months. Mortgage credit flows increased strongly in the first half--especially at thrift institutions, whose fund availability was enhanced by the advent of new deposit instruments.

In response to the drop in financing costs, as well as demographic influences, home sales turned up in 1982 and rose rapidly through the first half of 1983. By the second quarter of 1983, sales were up nearly a third from the final quarter of 1982; both new and existing homes shared in the sales gains. With the inventory of unsold new homes quite low, rising sales have supported a strong advance in new construction activity. Continuing the uptrend evident in 1982, starts of new single-family homes in the first five months of 1983 rose to a level about three-fourths above a year earlier--a sharper rebound than many analysts had expected in light of prevailing mortgage rates. Starts of multifamily units also have been quite strong so far in 1983, partly reflecting enhanced profitability in the markets for rental property. Low levels of housing construction over the past few years clearly left a sizable pent-up demand that has provided strong support for new construction activity.

### Government sector

Federal spending declined moderately during the first half of 1983, but the drop resulted mainly from transitory factors, particularly a reduced rate of accumulation of farm inventories by the Commodity Credit Corporation (CCC). Abstracting from these inventory swings, federal expenditures were still trending up in the first half. Excluding outlays of the CCC, federal purchases of goods and services, in current dollars, appear to have increased at an annual rate of more than 10 percent from the fourth quarter of 1982 to the second quarter of this year.

The federal budget deficit was extremely large in the first half of 1983. Because of changes in tax laws and, until recently, slow growth in taxable incomes, receipts have increased only moderately from the levels of two years ago. During this same period, spending has increased considerably, owing to increased defense purchases, recession-induced transfer payments, and, on average, relatively high payments to support farm incomes. As a result, the combined federal deficit (unified plus off-budget) accumulated to about $95 billion over the first half of 1983, three times the level of a year earlier. During the first half, direct federal borrowing (which does not include federally guaranteed loans or the debt of sponsored credit agencies) absorbed more than two-fifths of all funds raised in credit markets by the domestic nonfinancial sectors.

Real state and local government purchases edged lower in the first half of 1983, extending the gradual decline evident over the preceding two years. Real outlays for employee compensation and new construction spending were held down by the budget concerns still apparent among many states and localities. As in 1982, a number of governmental units raised taxes to relieve pressing financial difficulties. By midyear, however, some of the budgetary strains began to ease, as rising economic activity expanded the state and local tax base, boosting the sector's overall operating budget back into surplus.

Borrowing by state and local governments also increased rapidly, though part of the rise probably reflected a rush to market debt instruments in advance of a new requirement that securities be issued in registered, rather than bearer, form; the requirement deadline took effect on July 1, after having been postponed from January 1. In addition, tax-exempt borrowers took advantage of lower interest rates to refund or pre-refund bond issues that were sold when borrowing costs had been higher.

### The International Sector

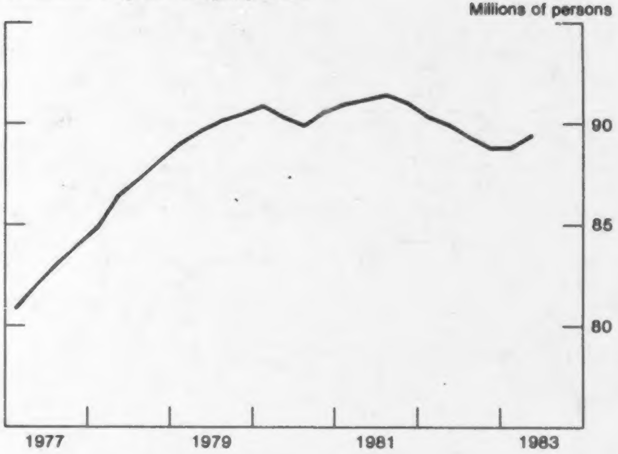
As in 1982, net exports continued to exert a negative influence on U.S. economic activity in early 1983; slow growth in foreign industrial economies and a strong dollar have both constrained export sales. At the same time, the vigorous expansion in the U.S. domestic economy pushed imports higher, so that the trade account showed an increasing deficit over the first half of the year.

An additional element limiting prospects for U.S. exports is the serious external financing problems facing a number of developing countries, including some that are major trading partners of the United States. Among these nations, reduced trade volume and depressed commodity prices have limited export earnings and--in the face of high world interest rates--made debt repayment difficult. So far, these repayment problems have been contained through an extraordinary degree of cooperation among borrowers, private creditors, national authorities, and international organizations; in many instances, existing debts have been restructured, new funds have been raised, and the borrowing nations are implementing programs to restore internal financial stability, to increase their debt-servicing capacity, and to convince international lenders of their creditworthiness. Nevertheless, the process of adjustment is still far from complete.

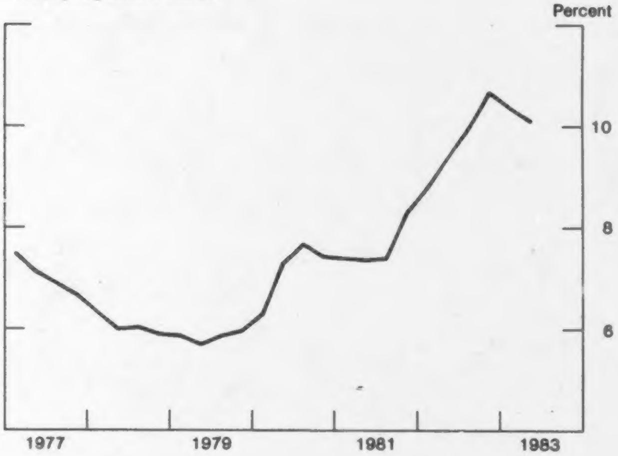
## Labor markets

Labor markets began to strengthen around the turn of the year, and by June, payroll employment had increased 1.1 million from its December trough, regaining more than one-third of the losses sustained during the recession. Job gains have been widespread over the past six months, with especially large advances in services and manufacturing. In manufacturing, employment increases during the past six months have retraced nearly a fifth of the 2 million jobs lost during the 1981-82 recession. Employment growth in the services industry, which had slowed during the recession, appears to be showing renewed vigor as the expansion has taken hold.

The total number of unemployed workers declined by almost a million during the first half of 1983, and the civilian unemployment rate fell to 10 percent, three-fourths of a percentage point below the postwar peak reached last December. Layoffs had begun easing late last year, and with labor demands strengthening through the first half, many firms have started



**Nonfarm Payroll Employment**



**Unemployment Rate**

rehiring. Despite these gains, jobless rates at midyear remained far above the levels of late 1979, before the two back-to-back recessions that added greatly to labor market slack in the early 1980s.

## Wages and Labor Costs

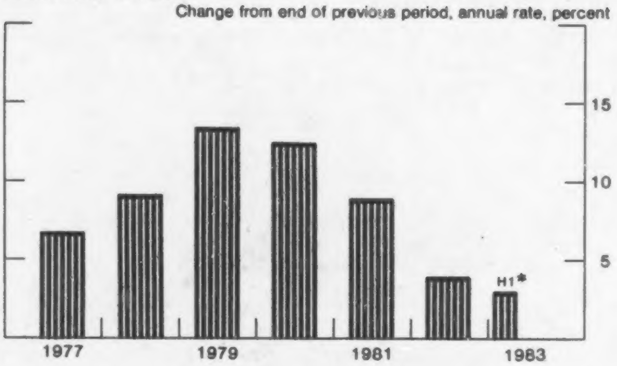
The falloff of labor demand during the recession, along with the general unwinding of inflation, led to a sharp slowing in the rate of wages and labor cost increases, and that slowdown has continued into the first half of 1983. From the fourth quarter of last year to the second quarter of 1983, the average hourly earnings of production workers rose at about a 4-1/4 percent annual rate, the slowest rate of nominal wage increase since the mid-1960s. But, because the rise in consumer prices has slowed even faster, the slower nominal wage gain has been consistent with increases in real purchasing power.

The slowing of nominal wage increases has been broad-based, affecting nearly all major industrial and occupational groups. With inflation easing, workers in general are feeling less pressure to catch up with past inflation or to try to stay ahead of anticipated future inflation. In addition, in industries particularly hard hit by recession, as well as by heightened domestic or foreign competition, workers have agreed to contract adjustments calling for wage freezes or outright wage reductions.

Unit labor costs also moderated further in the first half of 1983, as strong productivity gains reinforced the impact of smaller wage increases. In the nonfarm business sector, labor costs rose at only a 1-1/4 percent rate in the first quarter, and evidently the second quarter advance also was quite moderate.

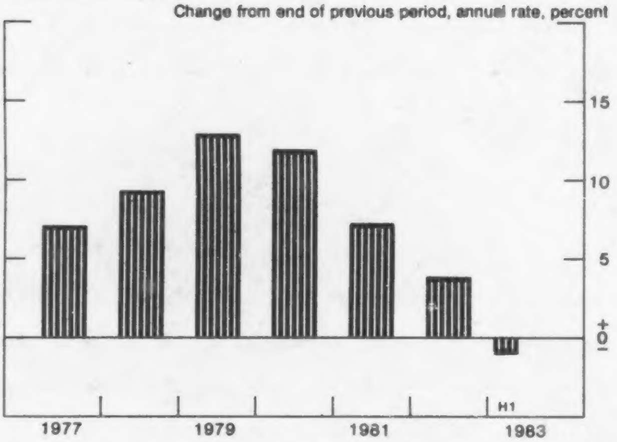
**Consumer Prices**

Change from end of previous period, annual rate, percent



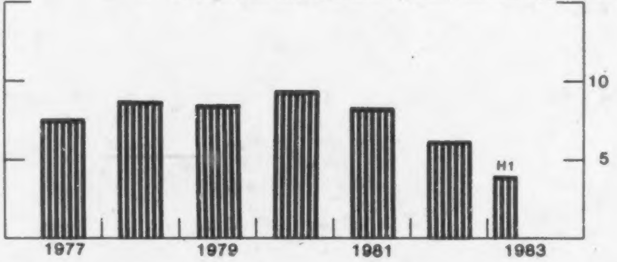
**Producer Prices**

Change from end of previous period, annual rate, percent



**Hourly Earnings Index**

Change from end of previous period, annual rate, percent



*Price changes for 1983 H1 are based on data for the December to May period.

The sizable productivity gains of recent quarters have been an especially encouraging development because they may reflect not only the customary cyclical patterns of an economic expansion, but also some improvement in the trend rate of productivity growth. Work rules in many establishments are being revised to enhance efficiency, and qualitative reports from the business sector point to strong efforts to trim costs and improve market competitiveness.

## Price developments

Price developments continued to be favorable in the first half of 1983. The consumer price index rose at an annual rate of only 3 percent from December to May, and over the first half, the producer price index for finished goods actually declined. An acceleration of prices from the first to the second quarters resulted mainly from swings in energy prices that appear to be temporary and from the transitory effects of adverse weather on the prices of some foods. The prices of raw industrial materials rebounded from depressed levels early in the year, but have leveled off in recent months. In other markets, including those for both consumer goods and capital equipment, price inflation in the second quarter still seemed to be trending lower.

Price increases during the past year have been the smallest since the early 1970s, and the period of moderating inflation has now extended over 2-1/2 years. Still, the recent period of slower price increases has by no means erased the memories of accelerating inflation during the previous two decades. The recent deceleration in prices occurred during a business recession, and there remains a deep-seated skepticism about whether the gains against inflation can be maintained as the period of economic expansion is extended. The task of economic policy is to overcome that skepticism by preserving the gains already won against inflation while sustaining the economic expansion that took hold in the first half of 1983.

## Section 4: The Growth of Money and Credit in the First Half of 1983

The 1983 ranges for the monetary and credit aggregates announced in February were chosen by the Federal Open Market Committee with the objective of providing sufficient liquidity to support economic recovery while continuing to encourage progress toward price stability. In setting those guidelines, the Committee recognized that the relationship between growth of the monetary aggregates and economic activity had deviated from usual historical relationships during 1982, and looking ahead, account had to be taken of the possibility that past patterns might be shifting in some respects.

Specifically, during 1982, monetary growth had been quite rapid relative to income; the velocities of both M1 and M2 had registered exceptionally large declines over the year. Although these declines in velocity were thought likely to be in part temporary--M1 velocity in particular commonly has increased appreciably in the early stages of a recovery--it also was felt that the experience of 1982 might well be indicative of a more basic shift in the underlying demands for money. Institutional changes have led to the increased availability of transactions accounts that bear interest, which would be likely to increase the public's willingness to hold M1-type accounts. These accounts are used partly as repositories for savings, as well as to support transactions, and this tendency was expected to be reinforced by the introduction of Super NOW accounts.

The Committee also recognized that the introduction of new deposit instruments had affected, and would continue to affect, the behavior of the broader aggregates. A very substantial inflow of funds into money market deposit accounts (MMDAs) from market instruments had greatly inflated growth of M2 at the end of 1982 and in the early weeks of 1983. It was anticipated that further flows into these accounts, and to a lesser extent into Super NOW accounts, would continue to affect the aggregates for some time, although the impact could not be determined with a high degree of accuracy.

In implementing policy, Committee members agreed that, for the time being, primary emphasis would be placed on the broader aggregates. It was expected that distortions resulting from the initial adjustment to new deposit instruments would lessen. The behavior of M1 would be monitored, with any increase in the emphasis placed on that aggregate dependent on evidence that its velocity behavior was assuming a more predictable pattern. Debt expansion, although not targeted directly, would be reviewed in assessing the behavior of the monetary aggregates and the stance of monetary policy. The Committee emphasized that, given the above uncertainties, policy implementation in 1983 would require a greater degree of judgment, involving crucially the evaluation of the relationship of monetary growth to movements in income and prices, until such time as the aggregates returned to more predictable behavior.

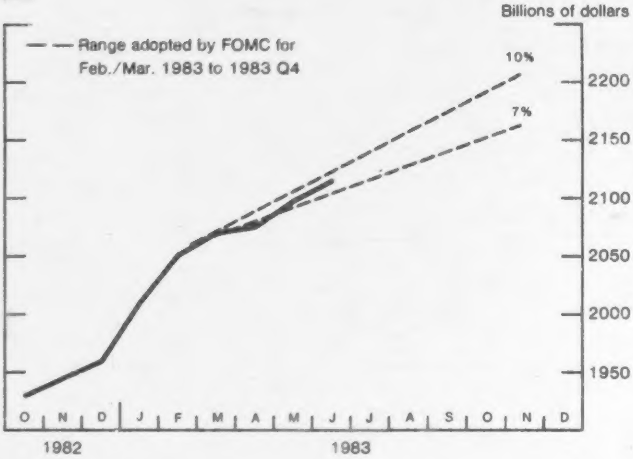
The specific target ranges announced in February were: for M2, an annual rate of 7 to 10 percent for the period from February-March of 1983 to the fourth quarter of 1983; and for M3, 6-1/2 to 9-1/2 percent for the period from the fourth quarter of 1982 to the fourth quarter of 1983. Also for the latter period, a tentative range was established for M1 of 4 to 8 percent, with the width of this range reflecting the relative uncertainty about the behavior of this aggregate. An associated range of growth for total domestic nonfinancial sector debt was estimated to be 8-1/2 to 11-1/2 percent, December to December, while bank credit growth was expected to be between 6 and 9 percent for the year.

Growth in M2 and M3 appears to be broadly consistent with the target ranges adopted in February. M2 expanded at a 9 percent annual rate from the February-March base period through June, a little above the mid-point of its range. M3 growth was somewhat stronger and, at 9-1/2 percent from the fourth quarter of 1982 through June, was at the upper end of its target growth path. In contrast, M1 continued to surge, with growth averaging 14 percent at an annual rate from the fourth quarter of last year.

In setting the annual target range for M2, the Committee selected the February-March base period to reduce the distortions resulting from the massive inflows to MMDAs following the introduction of these accounts in December. Moreover, the range of 7 to 10 percent was one percentage point higher than that set for 1982, to allow for some residual shifting from outside M2 into these accounts through the remainder of the year. There is growing evidence that the stock adjustment to MMDAs is abating; inflows to these new instruments slowed from around $17 billion per week in February to an average of about $1 billion weekly in June. Thus, it appears that the distorting effects of these instruments have, as expected, become relatively minor as time has progressed. The interest rates offered on these deposits--in absolute level and relative to other short-term rates--have fallen considerably from the extraordinary yields posted immediately following the introduction of this account. Since March, the average rates on MMDAs have been below rates available on virtually all market intruments, although they remain somewhat above the returns on money market mutual funds.

## Ranges and Actual Money Growth

**M2**

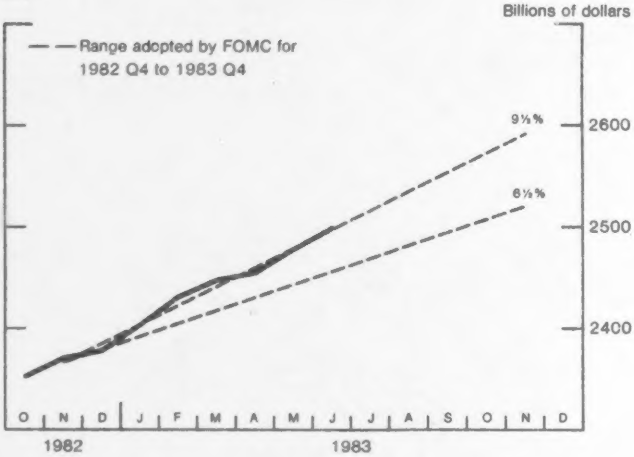


Rates of Growth
(annual rate)

Feb./Mar. 1983 to 1983 Q2
8.2 percent

Feb./Mar. 1983 to June 1983
9.1 percent

**M3**



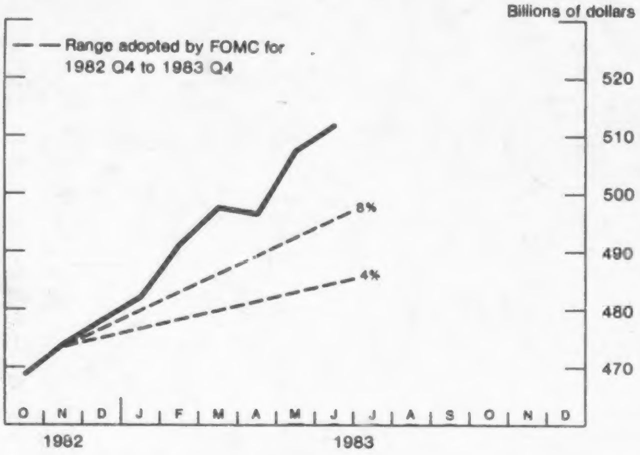
Rates of Growth
(annual rate)

1982 Q4 to 1983 Q2
9.3 percent

1982 Q4 to June 1983
9.6 percent

## Ranges and Actual Money and Credit Growth

**M1**

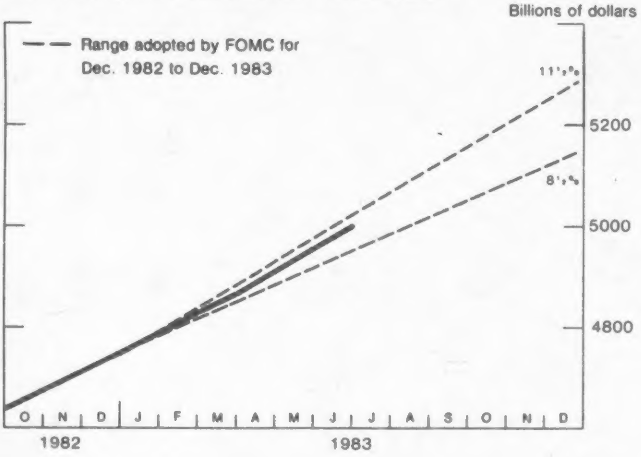


Rates of Growth
(annual rate)

1982 Q4 to 1983 Q2
13.4 percent

1982 Q4 to June 1983
13.9 percent

**Total Domestic Nonfinancial Sector Debt**



Rate of Growth
(annual rate)

Dec. 1982 to June 1983
10.6 percent

The recent behavior of other components of M2 also appears to reflect the waning of the public's initial adjustment to the availability of MMDAs. Runoffs of small denomination time deposits and M2-type money market funds, which were substantial during the first quarter, have slowed considerably, and in fact small time deposits registered a slight increase in June. Savings deposits, which likewise had declined by record amounts earlier in the year, increased at a moderate rate in May and June.

For M3, the range selected of 6 to 9 percent was identical to that for 1982. It was believed that M3 would be less affected by the new accounts because some of the funds flowing into them would come directly from large deposits and, in any case, many depositories have the option of reducing their issuance of large CDs in response to greater inflows to MMDAs or other core deposits. However, the extent to which this would occur would depend in part on changes in the public's perceptions of the desirability of insured deposit accounts relative to open market instruments and the willingness of depositories to make use of their new deposit authority to increase the extent of their financial intermediation. In the event, large CDs in the aggregate declined sharply in the months following the introduction of the new accounts, but have tended to pick up recently as inflows to MMDAs have slowed.

Besides running off large CDs, commercial banks responded to the influx of MMDA funds by increasing their holdings of liquid assets, principally Treasury securities; commercial bank holdings of Treasury securities expanded at an annual rate of more than 50 percent during the first half of the year. Small banks in particular, which rely less on managed liabilities than do large banks, invested heavily in these assets. Savings and loan associations appear to have relied largely on asset adjustments to MMDA inflows. These institutions showed a sharp acceleration in their holdings of cash and investment securities over the first quarter of 1983, and only moderate declines in large time deposits. In the second quarter, with slower inflows to the new accounts and an apparent pickup in mortgage lending, issuance of large time deposits by S&Ls registered a sizable increase.

The impacts on M1 of portfolio shifts into the new accounts are difficult to assess, but would appear to have been largely offsetting. Funds shifted into Super NOWs from outside M1 likely were about equal in magnitude to the outflow of funds from M1 into MMDAs. Nevertheless, M1 has been growing at a rate well above the 4 to 8 percent range that was set in February and much faster relative to nominal GNP than has been normal during periods of economic recovery, when velocity has tended to rise at above average rates. In fact, the income velocity of M1 continued to decline during the first half of the year, although the second-quarter decline was modest.

The decreases in M1 velocity may reflect in substantial part the changing nature of M1. With interest-bearing regular NOW accounts and Super NOWs making up a growing share of M1, this aggregate is becoming increasingly influenced by components that bear interest and thereby may attract "savings" as well as transactions balances. Indeed, there is evidence that the introduction of nationwide NOW accounts at the beginning of 1981 has made M1 more responsive to fluctuations in market rates. With market rates registering large declines in the latter half of 1982, the opportunity cost of holding NOW accounts--which carry a ceiling rate of 5-1/4 percent--fell sharply.

As money demand usually responds to falling rates with a lag, this would help explain the strong growth of M1 in the latter half of 1982 and early 1983. More recently, however, some of the strength likely reflected growing transactions needs accompanying the pickup in economic activity. Given the limited experience with NOW and Super NOW accounts, uncertainty surrounding M1 behavior remains substantial, but account needs to be taken of the possibility that more normal cyclical patterns may be returning.

Full data are not yet available for the second quarter, but preliminary indications are that the aggregate debt of domestic nonfinancial sectors grew over the first half at a rate somewhat above the mid-point of the 8-1/2 to 11-1/2 percent range projected by the FOMC, with a marked increase in the second quarter. This aggregate was swollen by federal borrowing, which has accounted for more than 40 percent of total credit flowing to domestic nonfinancial sectors since December. As indicated in the accompanying table, growth in federal debt has been very rapid in recent quarters, averaging in excess of 20 percent at an annual rate over the last four quarters. Residential mortgage financing and consumer credit have picked up since last year, reflecting the strengthening of these sectors. Business borrowing has remained moderate due to reduced needs for external financing and has been concentrated mainly in longer maturity debt; short- and intermediate-term business borrowing has been weak since the fourth quarter of last year. Borrowings by state and local governments were strong during the first half, as noted earlier, partly reflecting heavy issuance of tax-exempt bonds in advance of the July 1 registration date and borrowing for future refunding of higher cost debt.

## Domestic Nonfinancial Sector Debt

(Annual rates of growth, in percent)[1]

| | Total | U.S. Government | Households | Nonfinancial business | State and local govt. |
|---|---|---|---|---|---|
| Annually[2] | | | | | |
| 1979 | 12.1 | 6.0 | 15.1 | 13.5 | 7.4 |
| 1980 | 9.9 | 11.9 | 8.7 | 10.1 | 9.3 |
| 1981 | 9.9 | 11.8 | 8.2 | 11.3 | 7.0 |
| 1982 | 9.5 | 19.4 | 5.6 | 7.4 | 13.4 |
| Quarterly[3] | | | | | |
| 1982 | | | | | |
| 3rd quarter | 10.2 | 24.5 | 4.9 | 8.1 | 9.2 |
| 4th quarter | 9.8 | 24.5 | 5.9 | 3.7 | 18.2 |
| 1983 | | | | | |
| 1st quarter | 9.6 | 19.1 | 7.4 | 5.3 | 13.5 |
| 2nd quarter[p] | 11.4 | 23.0 | 8.5 | 5.4 | 19.1 |

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p--preliminary

1. Based on end of period data.
2. December to December.
3. End-of-quarter to end-of-quarter.

Commercial bank credit, boosted by heavy acquisitions of Treasury securities, has expanded at a 10-1/2 percent annual rate since December. Reflecting the general weakness in business demand for short-term credit, business loans at commercial banks were about flat over the first half, while bank mortgage and consumer lending has picked up. Some of the build-up of Treasury securities could be a temporary response to strong inflows to MMDAs, held as a hedge against possible withdrawals as rates on MMDAs remain below market yields. On the other hand, since some investors evidently shifted funds to insured MMDA accounts from open market instruments, the increase in investment holdings could mark a permanent increase in overall intermediation by commercial banks, thereby raising bank credit above its normal range. Indeed, as thrift institutions likewise have become more competitive with the introduction of MMDAs, the share of total credit extended by all depository institutions rose appreciably over the first half of this year; about 40 percent of domestic nonfinancial credit was extended by depositories during the first half, compared with an average of less than 30 percent from 1980 through 1982. During the first half, commercial bank acquisitions of Treasury securities helped to absorb the massive increase in Treasury financing, but, as private demands for credit pick up in response to rising business activity, such an absorption of Treasury debt may be more difficult within the context of non-inflationary growth of the monetary aggregates.

The **Chairman**. Thank you, Mr. Chairman.

May I note the presence of a quorum. We have 13 out of the 18 members of the committee. The chairman is here, Senators Hecht, Gorton, Mattingly, D'Amato, Trible, Proxmire, Riegle, Lautenberg, Cranston, Sasser, Dixon, and Dodd. So we will be able to conduct business and vote on your nomination at the end of your testimony and questioning period.

### CHRYSLER EARLY PAYOFF OF GOVERNMENT LOAN

Mr. Chairman, let me ask you a question first of all that is off the subject of your testimony today but I think is important in light of Chrysler paying their loan guarantees off early.

Senator John Chafee has told the Chrysler Loan Guarantee Board, on which you sit, that if the Board fails to exercise its Chrysler warrants he will introduce a bill to cut the Treasury's appropriations by $250 million, which is approximately the present market value of the warrants.

Also, Senators Trible and Hawkins urged selling warrants last June when the profit would have been in the neighborhood of $220 million.

If Chrysler offered the Board $250 million or the market value at the time of the offer, would you be willing—your vote—to accept that offer?

Mr. **Volcker**. The options in that area are under a very extensive review. Reselling the warrants to Chrysler is one possibility, if the price were fair and equitable in relation to the market.

One additional question that arises in connection with selling to Chrysler is, of course, Chrysler's cash and liquidity; we don't want to leave Chrysler in a weakened position. We have a responsibility to look toward the future viability of Chrysler, its performance in the automobile market as a going concern, and that is a variable to consider as to how much cash drain would be appropriate for Chrysler to absorb in terms of the possibility of rebuying the warrants.

But all of those options are under very close consideration currently.

The **Chairman**. I understand that, but it seems to me that one of the things Chrysler would like to do, which I certainly favor, is to get out from under the Government so they can make market decisions and determine their own future. I was a great critic of the loan guarantee program and voted against it. I still believe it was a bad precedent, even though it was successful, and I'm glad that it was; but nevertheless, it seems to me that if Chrysler is willing to pay the market value, that at least in the opinion of this Senator they ought to be allowed to do it, dissolve the Loan Guarantee Board, and run their company as a private corporation without the Government attempting to judge what they should do. And there's sentiment within the Senate along that line, as I have mentioned. The Government gets their profit and Chrysler gets back to running without Federal overseers.

So I can let you know there is some sentiment that fair market value seems to be fair to the Government and fair to Chrysler, if they are willing to do it.

Mr. VOLCKER. Let me simply say again that I think Chrysler is essentially out from under the Loan Guarantee Board when it repays its debt, but I think we all agree that disposal of these warrants at an early date would be desirable to just get the Government completely out of it. We don't want to carry the warrants in an equity position over a period of time, and selling them back to Chrysler is one option. It depends partly on the price.

Senator RIEGLE. Would the chairman yield at that point?

The CHAIRMAN. Yes, I would be happy to.

Senator RIEGLE. I would be very brief. I just want to say that I strongly support what Chairman Garn has said here. I think the time to resolve the issue is now and if an offer were to be made for today's fair market value, I think that represents a very handsome profit to the Government and the thing that I would be concerned about in the alternative is if there is inordinate delay here and the market can either go up or down and in a sense we put the Government in sort of a risk position of playing the market, and I'm not sure that's wise.

The other point I'd make is this, and that is if one presumes if Chrysler were to pay fair market value today for the warrants themselves that they in turn can turn to the private market which I think historically you have favored and I certainly favor, then this is probably a good time for them to do that.

Mr. VOLCKER. It's clearly a possibility. They can pay for them by taking them to the private market.

Senator RIEGLE. But it seems to me with this issue hanging over everybody's head that becomes more difficult. So I would just like to support what the chairman has said and I think fair market price would meet anybody's definition of a fair resolution of the problem.

Mr. VOLCKER. We haven't got that offer, by the way, I might say.

The CHAIRMAN. Senator Trible, I mentioned your name. Do you wish to make any comment?

Senator TRIBLE. Only that I concur that the taxpayers assumed substantial risks. Fortunately, the risk was well taken, but there should be a reward. There should be a payment and I believe the time has come for us to act.

The CHAIRMAN. Thank you.

### HOW THE IMF QUOTA INCREASE HELPS THE UNITED STATES

Mr. Chairman, you briefly touched on the IMF and, as you accurately stated, it did come out of this committee and was approved by the Senate. There's a good deal of opposition building in the House of Representatives. I have had some questions, even though I supported it all along until I found out Ralph Nader was against it and now that reaffirms my feeling that it's something that we should do.

But would you elaborate on the importance to our own economic recovery? In other words, going back to why I supported it, there is plenty of blame for banks in this country and in many cases their loan policies, and if I could have figured out a way to punish the banks without punishing the country, our own economy and jobs, I would have done so. I couldn't figure out how to do that, how to separate it out, and I felt it was a much, much larger issue than just the quick little political thing of let's not bail out the big banks.

I would appreciate it if you would elaborate on the importance to our own economic recovery of approval of the IMF quota increase.

Mr. VOLCKER. I would be glad to. Before I get to that point, if I may make one further point about the banks, because I think it's been one of the issues which raises questions in many people's minds.

I think all of us have a lot to learn from the experience of the past decade. As you well know, this committee attached provisions to the Senate bill dealing with supervision of banks in the future. The bank supervisors have already taken steps to strengthen and tighten supervisory and regulatory measures with respect to international lending by banks. I think it ought to be clear that that is integral to the IMF legislation itself—the legitimate, necessary attempt to look ahead to deal with the possibility of the recurrence of this problem.

So far as the IMF legislation itself is concerned, its importance lies in the fact that the IMF is at the very center of the effort of an international dimension involving hundreds of banks and dozens of countries and central banks—both the debtors and the governments of the industrialized world—to achieve the adjustment that is necessary to put this situation on a sustainable basis over time and to provide the interim financing. The IMF is necessary to make this a viable and orderly procedure.

The IMF is at the center of both aspects of that process. The adjustment process, in the first instance, and that they bring a little money to the table—not to replace bank financing but to supplement and, indeed, provide the center for more. If that process breaks down—and we are dealing not just with money but with the intangibles of confidence and willingness to go ahead in this difficult area—if that process breaks down and we have a string of defaults by these countries, it clearly will impact back on the capacity of those banks in the United States that we are most directly concerned with and on other major banks around the world to finance economic expansion. If their capital positions are weakened, if their stability is cast in any doubt, the natural reaction is going to be to cut back on other types of lending, particularly lending that involves any kind of risk at all and a lot of lending does. It will react back on the interest rates that they pay and must pay, and the interest rates in dollar markets generally. It could react back on the exchange rate. It could indeed lead to a flight to the dollar that would damage our trade position.

I think there is a very substantial risk that a breakdown of the effort to manage this debt crisis, in which the IMF is right at the center, would feed back in a most adverse way on our ability to finance recovery, and I think that is the essential American interest and the urgency in this bill.

### RECENT DECLINE IN $M_1$ VELOCITY

The CHAIRMAN. What, in your opinion, has been the cause of the recent decline in $M_1$ velocity?

Mr. **Volcker**. A structural reason is the fact that we now have one-third of the deposits in $M_1$ in the form of NOW accounts that pay interest; that's new, only 2 or 3 years old. We had a decline in interest rates last year that was quite sharp, as you know.

You would expect that during a period of declining interest rates velocity might decrease, and that's been a normal cyclical pattern in the past. We slow down from the trend, if not actually decrease.

Against historical experience, we have had the abnormal phenomenon of a sizable decrease for something like six quarters, which is unusual. Part of the reason seems to be that as interest rates fell sharply, the interest rate return forgone for holding $M_1$ in the form of a NOW account was cut very sharply. The Treasury bill rate was as low as 7 or 8 percent for a while. NOW account rates were a little over 5 percent, so the expense of holding money was reduced to about 2 percent for people who had NOW accounts.

Under those circumstances, it's not surprising people want to hold more in the form of NOW accounts than in the past, when they only got zero interest on a demand deposit. That appears to be a factor that may be changing both the trend and the cyclical characteristics of $M_1$.

I would not argue that that explains the whole thing by any means. I think we had very difficult economic circumstances last year. We had a big change in the inflation rate which was on the plus side. The uncertainties in the business picture, plus the progress against inflation, could well have led to—in this case temporarily, I think—deciding to hold more cash, and that gets reflected in a decline in velocity.

I would point out that in recent months, particularly, the speed of the increase in $M_1$, while the NOW accounts tend to dominate—has also extended to currency and demand deposits. That is one factor that raises the question about whether the speed isn't indeed, too great. I think it is.

The **Chairman**. Well, if you get an increase in speed, could you get a surge of spending again?

Mr. **Volcker**. Yes.

The **Chairman**. Even though money growth is slowed?

Mr. **Volcker**. Yes, you could indeed. $M_1$ is only one indicator, and we are looking at the broader aggregates and, in fact, putting more emphasis on those.

$M_2$ had a very sharp distortion earlier this year when the money market deposit account was introduced. But looking through that, that behavior seems more normal in terms of past experience. A surge in $M_1$ velocity once again could be in line with cyclical experience. You have to be cautious about it. But we have not looked at $M_1$ alone. In fact, we have deemphasized $M_1$; the growth of credit and the broader aggregates has been much more in line with our intentions, and it suggests that the inflationary situation and the economic situation will not be out of control because those other indicators are performing quite "normally."

The **Chairman**. Senator Proxmire.

Senator **Proxmire**. Chairman Volcker, you just told the chairman of the committee, Senator Garn, that you're putting more emphasis on the broader aggregates, and you just say emphasis, and when you presented your statement orally I didn't detect what I may have misread into your written statement.

In your written statement you indicate that the $M_1$ variable will be monitored rather than targeted, as the case of $M_2$ and $M_3$. That seems to me to be quite a difference and quite a change and if it is not targeting it seems to me that I could challenge you perhaps on whether or not you conform with the law which requires—and I read now—"that the Board of Governors shall transmit to Congress on February 20 and July 20, among other things, the objectives and plans of the Board of Governors with respect to the range and growth or diminution of the monetary and credit aggregates."

Doesn't that require that you give us a targeted range rather than tell us you're monitoring it?

Mr. **VOLCKER**. I don't think so, but we're getting into semantics. What we meant to indicate by that distinction between what we call a "targeted" range and a "monitoring" range is a difference in emphasis, which we reported before; that is, we are currently putting more weight on $M_2$ and $M_3$ and less weight, certainly than we did earlier, on $M_1$. That does not mean we ignore it.

Senator **PROXMIRE**. It does not mean what?

Mr. **VOLCKER**. It does not mean we ignore $M_1$. The growth in $M_1$ has certainly been a factor in our policy decisions, but it's a matter of degree, a matter of weight, and that's what's meant to be conveyed by this distinction.

Senator **PROXMIRE**. I don't disagree at all with the notion that $M_1$ had become a less measurable aggregate because of the super NOW accounts which pay interest. But it seems to me one of the apparent reasons that you're monitoring rather than targeting is because you don't have that much control over $M_1$.

If that's the case, why isn't it appropriate for the Congress to increase the list of monitored variables to include interest rates or nominal GNP? Interest rates, of course, is what the leader of our party, Senator Byrd, and the leader of our party in the House, Majority Leader Wright, have advocated.

Mr. **VOLCKER**. I'm tempted to say that I think interest rates and the nominal GNP get adequately monitored. The question of stating objectives for nominal GNP or real GNP or inflation in the short run is the subject matter of appendix 2 of my statement. I conclude there that while it is useful to set forth what we call projections or forecasts or assumptions of those variables, it would be counterproductive to give them the weight, in the short run, of something called objectives, for a variety of reasons that I try to outline in the appendix.

Among other things, it leads to an illusion that the Federal Reserve can control things closely enough so that in a 6-month or 1-year time period you can hit that kind of objective, to use the word.

Senator **PROXMIRE**. So you're saying that $M_1$ is still an objective but it's less of an objective than $M_2$?

Mr. **VOLCKER**. Yes. Less weight is put on it currently than $M_2$ and $M_3$ and more weight may be put on it later. If we had more confidence in the velocity outlook, I think we would restore more weight to it. It reflects a degree of uncertainty about the range of assumptions one has to make about velocity. It's certainly watched and looked at and taken into account in policy. It's just a question of the weight given to it.

### MORE RESTRAINT ON RESERVE POSITIONS

Senator **Proxmire**. Now there was an interesting division of opinion in the Federal Open Market Committee meeting on May 24. A majority of the members indicated that they favored marginally—and I quote—"marginally more restraint on reserve positions for the near term." In your testimony today, however, you indicate, and I quote, "a broadly accommodative approach with respect to bank reserves appeared appropriate."

Mr. **Volcker**. That was before that meeting.

Senator **Proxmire**. What's that?

Mr. **Volcker**. Before that meeting.

Senator **Proxmire**. That's right. And indeed the base for $M_1$ was moved forward and its percentage targets raised by one point.

What happened between the May 24 meeting and July 12 to persuade the Federal Open Market Committee to shift gears?

Mr. **Volcker**. I don't think we shifted gears between May and June or July. The actions since May have been in the direction of somewhat more restraint.

Senator **Proxmire**. Since May?

Mr. **Volcker**. Since May, yes.

Senator **Proxmire**. Well, aren't you raising $M_1$? Doesn't that move in the opposite direction?

Mr. **Volcker**. $M_1$ was already raised by events.

Senator **Proxmire**. Well, you just announced today that you raised it, or 2 days ago you announced it.

Mr. **Volcker**. We have accepted in effect the large upward movement in $M_1$ over the first half of the year as a base for looking at it into the future. That already existed.

The question was what was the meaning of keeping the old target? Did we want to move so aggressively as to aim at getting $M_1$ back in that original target, which would have taken a reduction or virtual stability from now until the end of the year. Did we want to aim for, essentially, a complete flattening out of $M_1$ for the rest of the year at a time when the other targets and the other aggregates were moving more or less in accordance with plan?

It is also true, whether one looks at credit or whether one looks at the broader monetary aggregates, that they are showing some symptoms of rising a little rapidly too.

Putting all this together, we turned toward a less accommodative policy, but I think that's perfectly consistent with the rebasing of $M_1$.

Senator **Proxmire**. During your May 24 meeting the Open Market Committee voted to tighten somewhat its current monetary policies, as I said. It's interesting to note that five of the seven board members, including yourself, voted to tighten, while three of the five Reserve bank presidents voted against that action.

I wonder if there's a message there. Does this mean that people in Washington are less sensitive to problems of the economy compared to people in the field?

Mr. VOLCKER. I don't think I would conclude that from that single vote.

Senator PROXMIRE. Why not?

Mr. VOLCKER. Five out of seven Board members, two out of five bank presidents in a particular vote——

Senator PROXMIRE. Three out of five were against it. They wanted to ease credit. They thought we needed lower interest rates.

Mr. VOLCKER. I think you will find more unanimity in subsequent developments. [Laughter.]

Senator PROXMIRE. They got the message. [Laughter.]

In your confirmation hearing before this committee you indicated that a $50 billion reduction in the deficit could have a meaningful effect on interest rates, and I think that's very welcome kind of advice that the Chairman of the Federal Reserve Board can give us. We both realize it would be practically impossible to persuade Congress to cut spending and increase taxes by $50 billion, but it might be a little less difficult if we had a measure of the beneficial effect of such an action.

What's your best judgment on this question? How much would interest rates be likely to drop if Congress really could cut the deficit by $50 billion? It would give us a figure that would be very, very helpful, believe me.

Mr. VOLCKER. I've looked at some of the evidence. Of course, you get mixed numbers coming out of econometric equations. If you talk about $50 billion from what it otherwise would be, you're talking about a quarter of the deficit. I just am very reluctant to give you a figure. So much depends on whether that was taken as an indication of——

Senator PROXMIRE. Give us a range. Give us something.

Mr. VOLCKER. One percent more.

Senator PROXMIRE. One percent?

Mr. VOLCKER. Compared to what it would otherwise be.

Senator PROXMIRE. In other words, we might get a drop in the mortgage interest rates or at least less of an increase of 1 percent?

Mr. VOLCKER. I would think in that magnitude anyway, yes. That would be my own judgment, and I would guess more than that if it were taken as a first step toward further progress, and that would be very important.

Senator PROXMIRE. Well, that's very, very encouraging.

Mr. VOLCKER. It's a difference from what it would otherwise be.

### BUDGET RESOLUTION AND MORATORIUM LEGISLATION

Senator PROXMIRE. Now the congressional budget resolution for fiscal 1984—and Senator Gorton had a great deal to do with this—requires both Banking Committees to report a resolution on monetary policy by September 30.

One of the assumptions behind this provision is any reductions in the budget deficit brought about by the budget resolution would reduce pressure on monetary policy.

Do you think if the budget resolution actually achieves or will achieve a reduction in the budget deficit that would reduce the pressure on monetary policy?

Mr. Volcker. My interpretation of that would be in that direction if the budget resolution were followed literally. It goes some distance in that direction, although some of the bigger changes are delayed for some time. As already has been suggested by someone earlier here today, there is great skepticism about whether even the provisions of the budget resolution will be carried through on the spending side and, perhaps even more particularly, on the revenue side.

As a matter of reporting what markets or others judge about the budgetary outlook, there is a very large degree of skepticism and a very large discounting as to whether the provisions of that budget resolution will in fact be enacted.

Senator Proxmire. Do you share that skepticism?

Mr. Volcker. Let me modify that statement. I share it in terms of what has happened so far. I have to remain optimistic that Congress will take a new look and in fact move more aggressively. I expect that will happen at some point. The question is, how soon? What I would hope is that with the economy expanding more rapidly with the evident threat that that presents for an earlier collision in the financial markets—in fact, I think we see some symptoms of that now—that the skepticism I just expressed will be overcome.

Senator Proxmire. My time is up, Mr. Chairman.

The Chairman. Senator Hecht.

Senator Hecht. Mr. Chairman, Senator Proxmire just spoke to you and I spoke to you the last time you were here—you requested the Congress cut the budget $50 billion. That was the first step you said.

Now if this doesn't happen, do you favor tax increases?

Mr. Volcker. Yes. I consistently said if you can't do it on the spending side, you should do it on the revenue side.

Senator Hecht. Isn't this in opposition to the administration in light of Secretary Regan's comments about the increased revenues brought on by the robust recovery?

Mr. Volcker. It may be. I'm not sure. I would emphasize the word "may."

Senator Hecht. All right. We'll go on.

Over the past 2 months I have heard from several financial advisers who are counseling their clients to stay on the sideline. Are these recent actions by the Federal Reserve going to convince these advisers that now is the time to get into the game, to get America on a prolonged recovery?

Mr. Volcker. The advisers will have to make up their own minds about that. I think we are in the midst of a recovery with some momentum, as I said, and certainly our actions are designed as best we can to encourage a continuing recovery with the fundamental of keeping inflation under control; it's that balance that you have to achieve.

Senator Hecht. I was surprised by your letter of support of the Treasury's deregulation bill. Do you still support the moratorium?

Mr. Volcker. Yes. I think the moratorium should be enacted promptly so that the situation can be held in place, so to speak, for a limited period, while the comprehensive legislation which is sorely needed can be debated and dealt with.

Let me say our support for that legislation is based upon a long series of discussions that we had. It fundamentally rests upon the proposition that there will be adequate supervision of the entire bank holding company, including the nonbanking activities.

Senator HECHT. What constitutes a limited time specifically?

Mr. VOLCKER. We proposed in legislation that you run the moratorium through the end of this year, on the assumption or hope that perhaps you could act this year. I would hope that you would act, if it's not possible this year, in a 9-month time perspective.

Senator HECHT. In your midyear report you state that there are several factors which could disrupt a lasting recovery—deficits, inflationary expectations, and a series of financial problems that plague the developing nations. In regards to developing nations, you state that the debt problem had been contained through extraordinary cooperation between borrowers, private creditors, national authorities, and international organizations.

Has Brazil ceased to cooperate?

Mr. VOLCKER. No. Brazil has taken strong steps recently, and I believe that they are now well on their way toward a new or revised agreement with the IMF that would create a foundation for making the adjustments that are necessary and the provision of the financing that is necessary.

Senator HECHT. Do you feel the latest money for the IMF will bring about a recovery in Brazil?

Mr. VOLCKER. I think that this legislation is essential for the IMF to continue to play this role and for people having confidence that it will continue to play the role. The money isn't necessary, in the short run, for Brazil or any other country. The quota looks ahead to next year and the following year.

Senator HECHT. Do you feel this amount will be all that we will be asked to contribute to the IMF?

Mr. VOLCKER. Not forever.

Senator HECHT. Let's say for the next year?

Mr. VOLCKER. For the next year, yes; for the next several years.

Senator HECHT. The next several years.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

### GROWTH CHANGE BETWEEN $M_1$ AND THE ECONOMY

With respect to following up on the $M_1$ discussion, so far this year the growth has been about 14 percent, well above your target that you had before, and now you have taken the target range up a percentage point and next year you mean to crank it back a percentage point.

I assume that you're changing the base. In other words, you're taking the 14 percent growth and folding that into the baseline so in effect you're measuring the new target off a changed base which just now includes that larger burst of credit growth in that area that's taken place. Is that right?

Mr. VOLCKER. Yes.

Senator RIEGLE. So if we wanted to, we could look at it really two ways. We can take the new range which is 5 to 9 percent and we could look at that on the basis of this changed base, or I suppose, if we wanted to, we could take and not change the base and go back and make a calculation and then it would be higher?

Mr. VOLCKER. Yes. I made that calculation but I don't know that I have it with me. You can obviously do that. You can get the same result at the end of the year by not changing the base but by changing the percentages.

Senator RIEGLE. If you have that, I'd appreciate your giving it to us for the record. I would not ask you do the calculation now, but I think that might be a little easier for people to try to make sense out of what's happening here if we look at it both ways.

Mr. VOLCKER. Here it is. If we used the same base but changed the ranges to get the same result, you would have a range of about 9.3 to 11.5 for the year as a whole.

Senator RIEGLE. I think it's useful to look at that because that is quite a dramatic change from what we had before. You can argue we needed that because of world change and the components of $M_1$ have gone through a change, but could you just take a minute and explain, if you take that higher figure, what would have caused the very substantial jump up from the old target to the new target if you stayed with the constant base?

Mr. VOLCKER. If I could give you an absolutely adequate explanation, we would be giving more weight to $M_1$. I can give you an explanation that goes in the right direction, but I don't want to pin it down to the last percentage. Again, we think that one factor here is the fact that NOW accounts have become the dominant form for holding the transactions balance of individuals, and that probably makes it more interest rate sensitive. When interest rates go up and down over the cycle, you would expect bigger changes in velocity, and that probably changes the trend to some degree over time. You've had a relatively long-term trend of $M_1$ rising about 3 to 4 percent less than the GNP. I would not be surprised to find 10 years from now, looking back, that that trend would have changed so that $M_1$ rises more rapidly relative to the GNP, but how much more rapidly is, in advance of the event, very difficult to judge.

We would also expect that the payment of NOW accounts at a fixed interest rate—they have a ceiling, except for the Super NOW accounts—that may give more fluctuations in $M_1$ for every change in interest rates. You have a fixed rate in $M_1$, you have a market rate that is fluctuating, and when market rates fluctuate it has a disproportionate effect on willingness to hold $M_1$.

We now have Super NOW accounts. Looking ahead a little further, I think we're going to be proposing legislation to pay interest on demand deposits, generally, without a ceiling. When you introduce that kind of change, it is going to change the growth relationship between $M_1$ and the economy.

As a first approximation, you would think, if interest were paid on demand deposits and on $M_1$ generally, $M_1$ ought to grow about in line with the economy. It probably won't have much cyclical fluctuation under those circumstances, if the interest rates go up and down with the cycle. NOW account interest rates are not going up and down with the cycle, but once those interest rates are freed, they will presumably go up and down with the cycle.

You may have a situation—we don't have it yet and I can't prove it because we're not there yet—of $M_1$ growing much more in line with nominal GNP in the future, once that further change is made.

### DANGER AHEAD IF DEFICIT NOT CUT

Senator RIEGLE. I think that's a helpful explanation.

Let me move to something else in your statement that I think is very important. Starting on page 3, and I'd ask you to respond as I go along here, but it seems to me that what you have given us here is a very strong warning today that our financial house is not yet in order and that there are some real problems that have to be dealt with if we're going to get the kind of future economic performance that we want.

Mr. VOLCKER. I'm trying to make the warning as strong as I can responsibly make it.

Senator RIEGLE. Without scaring people to death.

Mr. VOLCKER. Yes.

Senator RIEGLE. The tightrope you're on of trying to maintain confidence and help create a more positive confidence and at the same time be realistic about the dangers is a very difficult assignment and I appreciate the difficulty of it.

But I want to draw attention to three or four things you said here because I think the statement that you have given the committee today, the prepared statement, is the strongest one that I have seen you give yet in terms of highlighting the dangers and the concerns you have and giving us a warning about some policy changes that need to be made, and I just want to touch on two or three points here.

On page 3, you say here, "the underlying or structural position of the budget will deteriorate without greater effort to reduce spending or increase revenues." We talked about that before. You say here, "We would be left with the prospect that Federal financing would absorb through and beyond the mid-1980's a portion of our savings potential without precedent during a period of economic growth."

You go on on the next page and you say in summary of the next paragraph, "To put the issue pointedly, the government will be financed, but others will be squeezed out in the process." I think that's a very clear expression of your concern that if things are not altered that's the box that we are in and the problem we face inevitably without further policy changes.

Then you go on to say, "While that threat has been widely recognized, there has also been a comfortable assumption that the problem would not become urgent until 1985 or beyond." I'm repeating what you have given us this morning. You say, "That might be true in the context of a rather slowly growing economy." Then you say, "But the speed of the current economic advance certainly brings the day of reckoning in financial markets earlier." And that means that this is a serious problem and it's closer in, and I appreciate your honesty in saying so, and that may well mean that it could be prior to 1985 which is with specific reference to the reference you make in the prior line.

You then go on to talk about the only way we're going to be able to continue to finance this deficit that we're running is with foreign money which we are doing at least on a short-term basis is if we continue to run a deep trade deficit. That's contained in the next paragraph.

You go on to say that there's been some tendency for overall measures of money, liquidity and credit to rise recently at rates that, if long sustained, would be inconsistent with continuing or even consolidating progress toward price stability, and you get into the price-wage concerns you have a little bit later on.

But then you say, "All of this, to my mind, points up the urgency"—your word—"urgency to reduce the budgetary deficit" and you continue in that vein. "Left unattended, the situation remains the most important single hazard to the sustained and balanced recovery we want."

Then you go on to speak about the IMF problem, the wage and price problem. I might just say parenthetically, I don't find much in here on unemployment. I think there ought to be more. I say that as a suggestion to you.

But the bottom line of what I'm getting here and your statement is is that you're putting the committee and the Congress and the country on notice that we have to make some additional major financial adjustments here if we're going to be able to have the outcomes we want; namely, lower inflation rate, lower unemployment, and economic growth, a sustained economic recovery.

Is that a fair summary of what you're telling us?

Mr. VOLCKER. Yes; and I particularly appreciate the emphasis on the need for early action, because I think we have deluded ourselves—particularly against the background of the speed of the recovery—that this problem can wait.

Let me give you some figures for growth in credit in the second quarter according to our preliminary estimates, which I think illustrate the problem. The total amount of credit to the domestic nonfinancial economy went up by about $100 billion, a pretty big jump, in the second quarter. These are all seasonally adjusted annual rates.

The U.S. Government went up about $50 billion. As I recall it, the Government borrowed something like $40 billion last quarter. That's supposed to be a quarter of seasonal surplus. Far from being a quarter of seasonal surplus, the Government had to borrow $40 billion.

What's listed here as private nonfinancial—mainly mortgage credit and consumer credit—went up about $45 billion, almost $50 billion, in the second quarter.

The nonfinancial businesses went up hardly at all; they were at a low level. That's not atypical in the early stages of recovery. State and local governments went up quite rapidly.

What happens when the nonfinancial business begins borrowing to support recovery—which they are going to do sooner or later and more so the more rapidly the economy expands. The current level of their borrowings is about $50 billion below what it was last year when the economy wasn't all that strong. It's $100 billion below what it was in the second quarter of 1981. It is at recession-depressed levels.

What happens when that changes and Government borrowing hasn't subsided but continues to go up, and presumably mortgage credit will continue to go up and consumer credit will continue to grow in an economic expansion? What happens when you get that swing-around in business credit? There isn't any room for it, not within our credit targets, not within our monetary targets.

Senator RIEGLE. Well, I'll just conclude by saying there are some people today who feel that now—and I think it's partly reflected even in the big uptake in the market yesterday, but more and more you hear it—that now we're into such a strong recovery phase that we don't really need to do anything else. In other words, there are no more major financial policy changes that are needed, that this whole thing now is going to take care of itself, and what I hear you saying in the most moderate way that you can phrase it with words, is that that's not the case.

Mr. VOLCKER. I tried to say it in the most forceful way.

Senator RIEGLE. And that other major financial adjustments are needed here.

Mr. VOLCKER. Yes.

Senator RIEGLE. Thank you.

The CHAIRMAN. Senator Gorton.

### CREDIT, WAGE DEMANDS, AND PRICES

Senator GORTON. In a sense, following up on what Senator Riegle has said and one of Senator Proxmire's statements as well, we tend often to treat the Chairman as the Federal Reserve, but as Senator Proxmire pointed out, occasionally there are differences among members of the board.

I'm interested in the rather arcane and mysterious nature of the exercise you follow in arriving at target ranges for money aggregates and credit aggregates.

Looking at credit for a moment, how do you arrive at a number which you think to be a desirable expansion of credit and how do you decide how accommodative to be to such things as an increase in Federal financings?

Mr. VOLCKER. This is a difficult question because this is the first year we've targeted aggregate credit and so, in a sense, we are still learning in that area.

But if you look at that particular aggregate that we are now targeting, its long-term trend is very close to the trend in nominal GNP. There are some cyclical fluctuations in all these things, but the trend over a period of time is flat.

I think you start with the presumption that that trend is going to continue. That trend has been as stable as any of these trends in relationship between financial aggregates and the nominal GNP over a long period of time.

We looked more closely as to specific influences this year, such as the Government deficit, the financing picture of businesses, and so forth, and we tried to reach some conclusion as to what is tolerable, in connection with the kind of economic outlook you would like to see of recovery and declining inflation.

As I indicated in the statement, some of that analysis suggested that this year credit might reasonably rise more rapidly than GNP.

That gives me a little concern, simply because you start with the presumption that the basic trend is not much different and that may be perfectly acceptable for 1 year and the range encompasses the area of nominal GNP. But we want to look at that pretty hard next year and in the future, because I wouldn't want to contemplate that rising faster than GNP over a period of time. That would imply certain peculiarities and weaknesses in the financial structure, or excess liquidity and inflation. I think those are some of the considerations that we brought to bear.

Senator GORTON. In February when you testified, you emphasized the importance of moderation in wage demands in keeping the rate of price increases down. That raises two questions in my mind.

First, are wage increases a symptom or a cause of inflation?

Mr. VOLCKER. That's been argued interminably through the years and I would say in some circumstances it is one and in other circumstances the other. I don't think they are particularly an independent cause; that's probably been true for a decade or more. But they can be a very powerful factor in maintaining an inflationary momentum once started. I think that was certainly true in recent history. Other times it may have been a more independent cause.

But what I am concerned about now is that we are coming off the period of 10 years when roughly a 10-percent wage increase became quite normal. That was understandable in the context of accelerating inflation. But if people really think that is normal and they want to go back to that kind of a pattern, then you pose a very striking conflict between monetary growth, credit growth that seems desirable in terms of holding inflation under control, and the amount of money that's required to finance that kind of wage increase. The net result would be very unsatisfactory economic performance and you would end up with lower real wages and unemployment and all the rest.

How do you approach that problem? The wage trend has been favorable—favorable in both senses of being low in nominal terms but growing in real terms—and that's what you want. You want a situation where wages are moving toward a noninflationary level in nominal terms but where the average worker has more real income. That's what we have had for the past 18 months. We've had that combination for the first time in more than a decade. We've had an increase in real income for the first time in 4 years.

If we can keep that process going, then in a sense, we've won. How do you do that? I would emphasize two things. We haven't been very successful in doing it directly, through the so-called incomes policy, but I think you have a posture of public policy—monetary policy and fiscal policy—that says to the world we are not going to stand for a resurgence of inflation, so don't expect that. Nobody is going to be completely convincing, given the attitude of the last 10 years, but we can certainly move in that direction. We must be as convincing as we can be. The more time that passes, the more convincing we can be.

The second thing we can do is make sure that we are not aiding and abetting the process in terms of our own trade policy by just looking at our own interest. Throwing on import quotas every time an industry gets in trouble is not giving the right signal, in my opinion. We can look to a whole string of domestic measures that have been in place for years and years that one would hope, in an expanding economy, could be alleviated or eliminated. The old Davis-Bacon kind of approach, the Government Services Contract Act kind of approach, are striking examples. A little progress has been made recently in easing some of the repercussions administratively.

You could argue, and it has been argued in the past, that raising the minimum wage too rapidly tends to ratchet this up. I think that danger has been avoided recently. But there are many other areas where attention can be given to internal competition, so that a firm can see rather directly the repercussions of its own actions in excessive pricing or excessive wages is going to hurt its competitive position. If that message isn't there, then there's no incentive for restraint.

Senator GORTON. From the first time that I've heard you until right up to 15 or 20 minutes in answer to an earlier question, you have indicated a strong preference for closing the Federal deficit by reducing spending, but you've gone on to say that if tax increases were the only available tool or were a proper combination tool, then that was a better course of action than allowing large budget deficits to continue.

Does that general opinion on tax increases extend to indexing personal income tax rates? In particular, do you feel that repeal of tax rate indexing would send some kind of signal to the economy that Congress was not serious about fighting inflation?

Mr. VOLCKER. I know there are strong arguments on both sides and I'm sympathetic to some of the arguments for indexing. But, on balance, I would prefer not to have tax indexing.

Senator GORTON. Finally, in February you testified also before this committee that the great liquidity created by new money market deposit accounts would show up as reduced bank lending rates. Indeed, at that time, you suggested that it was beginning to happen.

What happened to that interest rate decline and why?

Mr. VOLCKER. I think market rates were stable since that time until recently. With the recent increase in market rates, I don't think you can say that bank lending rates are high relative to market rates currently. I think you could make that case in the context of our earlier discussion last fall during certain periods. But market rates stopped going down when the prime rate got reduced to 10.5 percent; based upon past relationships, it didn't look particularly high relative to market rates. That's certainly true now, much more so than in February or whenever we met before.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Gorton.

Before I turn to Senator Lautenberg, I would think it might be wise to warn the committee of a procedural problem. Due to the defense authorization bill on the floor and the difficulties we've had there, I've been advised that each day there has been a routine objection to committees meeting past 12 o'clock; so, I just wanted to let my colleagues know that. We will also have a cloture vote sometime in that period. So, we do have a time deadline of noon. I'm not trying to preclude anybody from talking. It's just a warning that we have some procedural problems beyond the control of the committee.

Mr. VOLCKER. I might say to Senator Gorton, just looking at some numbers here, that consumer lending rates did continue to come down through the spring somewhat, at commercial banks.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman, and I take your caution personally and thank you very much. My comments and my questions will be fairly brief. Unfortunately, one of the disadvantages of arriving on the seat here late—and I don't mean this day, I'm talking about my seniority—has one asking questions after many of the good ones have been presented, but I just have a couple that I'd like to review.

### FULL EMPLOYMENT AND PRODUCTIVITY STILL FAR OFF

It's very obvious, Chairman Volcker, that I think Senator Riegle's comments were those that you agree with very correctly and that is that through this optimism or perspective on the rapidly growing economy that there are warnings, there are concerns, and I think even in your written testimony when you say there should be no assumption that monetary policy, however conducted, can itself substitute for budgetary discipline; that while we have the chance to continue with the recovery, the risks are indeed great and that we should not expect, if your comments are clearly understood, that monetary policy can substitute for anything other than the set of natural adjustments that have to take place, including the reduction of the debt.

Is your voice heard in the White House or in the policymaking centers on fiscal policy? Is there communication directly or, as I said in my opening statement, are you expected to pick up the problem and, like a good soldier, knowing full well that indeed the battle may be a futile one?

Mr. VOLCKER. My views are no secret, and I have expressed these views on many occasions. They are the same privately as they are publicly. I think you have witnesses from the administration later who can tell you how they listen and what their own views may be.

Senator LAUTENBERG. In that connection, I think we have some testimony coming from Chairman Feldstein who says in his comments, "I think that the Federal Reserve policy announced yesterday by Paul Volcker bringing $M_1$ growth rate down to the 5- to 9-percent range for the remainder of the year is appropriate." He goes on to say that it's very important to bring the actual $M_1$ growth rate down to this range.

If I heard you correctly, I think you see the Federal Reserve acting more in a monitoring position, rather than aggressive limiting of the growth rate. Do I understand that correctly?

Mr. VOLCKER. No; I wouldn't say that, looking at the aggregates generally. Again, it would depend upon the performance of all of them viewed as a whole. We would certainly be more aggressive if the general tendency was to rise. If we had one aggregate that was out of line and the others were clearly within line, I think we would be less aggressive, but we would have to look at all of them.

Senator LAUTENBERG. I was interested in your response to Senator Gorton's question about whether wage increases might follow or lead, and I think there's always a debate about that, whether, in fact, wages lead or lag price increases. It's my view that labor has taken a big chunk of the recession results that we have seen and that we are just now beginning to see I think some price decreases or price restraint catch up with that.

However, I hear that the increase in purchasing power of real wage increases is limited to a very small segment of our society. In fact, I think it kind of counterbalances out to 30 percent of our people are enjoying about 65 percent of the real purchasing power. Are you aware of those figures?

Mr. VOLCKER. I haven't got a breakdown of those figures, but if I might comment, you say labor has borne the brunt of the recession. It has certainly borne the brunt in terms of unemployment. Looking at those working, these averages say that those who kept a job have been better off, and more better off than they've been for some years; that there has been a real increase in average wages. My impression is that that has been rather widely dispersed.

Senator LAUTENBERG. That's true with the exception of a very important factor, and that is that there are more people out of work for a longer period of time than we have ever experienced.

Mr. VOLCKER. Clearly, there is a severe unemployment problem.

Senator LAUTENBERG. And the prospects of returning to either the jobs they held or new jobs is relatively grim. We don't see the kind of robust return to employment that is apparent in the growth in the economy.

Mr. VOLCKER. Employment has been increasing pretty fast recently. The unemployment rate is down about 1 percent, but employment is up over 1 million, as I recall the number, in 6 months. Of course, it's important to keep that process going and to get an increase in the labor force during this kind of period.

You see on an industry level that restraint on cost generally and on wages in particular, to keep an industry competitive, is going to be favorable to employment in that industry.

The automobile industry, the steel industry—very high wage industries compared to the average—have clearly had competitive problems. They have clearly had unemployment problems. The competitive problems are related to the unemployment problems, and the more that can be done in terms of those competitive problems, the better off all the workers will be in that industry, including those presently unemployed.

Senator LAUTENBERG. Unfortunately, what's happening I think is that rather than go to a responsible fiscal policy, raising the revenues, watching our expenses carefully, I think there is a tendency now to believe that we can substitute trade restrictions and other kinds of restrictive policies for that, and it gets to be a popular theme, but I think ultimately does not get a very positive result.

Mr. VOLCKER. I think it works against the very employment and real income objectives we need, if it leads to noncompetitive industries.

Senator LAUTENBERG. Chairman Volcker, just one more question.

This afternoon we have Professor Blinder testifying. He's going to say that it's premature to be concerned about a rekindling of inflation now. He maintains "that it would take 2 to 3 years of real growth at a 6-percent rate before we begin to approach the full employment zone."

What do you see in terms of capacity constraint kind of problem, given the pace of recovery?

Mr. VOLCKER. It's going to take some time to return to what you think of statistically as full employment or a high level of capacity utilization, but I have to disagree entirely that you don't worry about inflation during this period.

We have learned, I would hope, from long experience that we have to worry about inflation all the time or it's going to get ahead of us and then it's much more difficult to deal with.

Senator LAUTENBERG. Keeping my promise, Mr. Chairman, I yield up my time before I get the white slip.

The CHAIRMAN. Senator Mattingly.

### PUBLICITY OF $M_1$ AND TAX INDEXING

Senator MATTINGLY. Mr. Chairman, with all the discussion about $M_1$ which has constantly gone on ever since I have been in Congress, I guess it depends on which side of the issue you're on that particular day, but the "M" may want to stand for manipulation. I think some people have accused others of wanting to manipulate $M_1$ or said $M_1$'s been manipulated, but I'm glad to hear you say there's going to be less emphasis placed upon $M_1$.

My concern is that the debate that's constantly gone on about $M_1$, the coverage given by the press on $M_1$, terrifies the business sector, because no one knows what to expect.

My question to you is, why doesn't the Fed abandon the use of $M_1$ or use a more reliable indicator such as $M_2$?

Mr. VOLCKER. Through the years, I think it's fair to say that $M_1$ has been a reasonably reliable indicator, probably more reliable than some of these other indicators. We do not believe that is the case right at the moment because of the uncertainties. That's the reason we have deemphasized it, but not forgotten about it, and we will appraise developments in $M_1$ and see whether it returns to a more predictable relationship.

Senator MATTINGLY. You say it's been deemphasized, but that's never the way it gets played in the media. When the people look at it, they very seldom see anything about $M_2$ or $M_3$. It's always $M_1$.

Mr. VOLCKER. There's certainly more attention paid to $M_1$ possibly because we publish it weekly while data for the other aggregates is not publishable weekly, but I would think the emphasis on $M_1$ recently has not necessarily reflected a basic increase in emphasis on $M_1$, but simply the fact that it's been running as high as it's been running. If it were running 9 percent or 8 percent, it would still look high historically, people probably wouldn't be looking at it as much as they do when it's 12, 13, and 14 percent. That's consistent with deemphasis.

I think what's gotten people looking at it a bit is that rapid growth has now persisted for quite a period of time. It is, in my view, evaluated together with other factors, a source of concern—not just looking at $M_1$ alone, but looking at it in the context of other things going on.

Senator **Mattingly**. Since I have been in the Congress, $M_1$ has always had erratic growth, if we look back in 1981 and 1982. What about the possibility of publishing these figures less frequently, because it does have an impact on the financial market. I think maybe the stock market yesterday may be the latest indicator of the market interest in monetary policy.

Mr. **Volcker**. I have railed against these weekly figures before and so has the chairman of the committee. The only problem is we would probably be worse off with the speculation that would take place if we didn't publish them weekly. We're not dealing with a situation where $M_1$ has gone up at a 14-percent rate for 2 months. It's gone up at that rate on the average for 6 or 8 or 9 months. That's an entirely different perspective. If it had just been a very brief period, it probably would have little attention. I think at some point it should get some attention. We have not given it the same emphasis that we gave it earlier, but, again, that doesn't mean zero attention. We don't put blinders on when we look at the numbers.

Senator **Mattingly**. I don't want to beat that to death, but possibly you're not giving it the attention, but yet people on the outside read newspapers and watch TV and listen to the radio and the emphasis is on $M_1$. You don't hear anybody talking about $M_2$ or $M_3$, never. Why don't you consider using some other measure other than $M_1$?

Mr. **Volcker**. We do.

Senator **Mattingly**. I meant dropping possibly $M_1$ out or making it——

Mr. **Volcker**. I think it would be misleading. In my personal opinion, it would be misleading to drop $M_1$ because while there is attached to it the need to interpret these recent movements, and while we have in the light of that uncertainty, deemphasized it, I'm not ready to say it is entirely meaningless, when the movements are as large as they have been for as long a period—and it takes both of those things. Still, it's a matter of degree. We're certainly not reacting to $M_1$ alone. We are looking at it in the context of all these other indicators; our basic targets remain $M_2$ and $M_3$.

Senator **Mattingly**. On the question of taxes, I believe you said you were opposed to tax indexing; is that correct?

Mr. **Volcker**. On balance, yes.

Senator **Mattingly**. Are you opposed to the indexing that was passed, the indexation of the taxes—are you opposed to what we did 1½ years ago?

Mr. **Volcker**. Yes. To put that in context, I don't like the tendency toward indexing in general and, in that general context, I have been reluctant to see tax indexing. I expressed that at the time it was passed.

Senator **Mattingly**. OK. In your future dealings with the President, are you going to recommend to him the repeal of tax indexing? Are you going to recommend to him that we raise taxes, because you said earlier that we need to raise taxes?

Mr. **Volcker**. I recognize that the President has a very strong view on tax indexing.

Senator **Mattingly**. That's right. I do, too.

Mr. **Volcker**. I think he is, as I understand it, quite committed to that course. You asked me for my personal opinion and I gave it.

Senator **Mattingly**. Will you be going to the White House or will you be talking about it with him?

Mr. **Volcker**. My view on indexing is known, and my view on the necessity for some revenue increases, if expenditures can't be reduced in the dimension we're talking about, is well known. It's not new. I talked about it in the White House.

Senator **Mattingly**. We don't have much impact on monetary policy in the Congress but we do have an impact on the fiscal policy. We certainly ought to leave monetary policy to you. But in the fiscal policy arena—and you and I have talked about this—we need to reduce spending.

Why do you want to go back to the way it used to be that got us in all the trouble in the first place?

Mr. **Volcker**. I shouldn't be getting into the details of fiscal policy. That is, indeed, your job. My emphasis is on the fact that these deficits are too big, and that you should deal with them however you can. My basic economic judgment is, to the extent you can deal with them through spending, you're going to have a better economy. You asked me my judgment. If you tell me that's not possible—as some people tell me that's not possible or only possible to some degree—and you're faced with the dilemma of not having reduced spending far enough, do you then accept the budget or do you increase revenues? If you're faced with that problem, I recommend you increase revenues.

Senator **Mattingly**. You're for the fiscal year 1984 budget resolution that passed the Congress?

Mr. **Volcker**. The budget resolution involves a lot of particular judgments about particular programs. I have nothing to say about them, and properly have no recommendation about them. The budget resolution, literally enacted, just looked at from what comes out of the other end of the sausage grinder, so to speak, would make some progress toward reducing the deficit, and I think that is constructive.

Senator **Mattingly**. Do you think there could be a comparison made between the budget resolution and $M_1$, in that both of them ought to be deemphasized?

Mr. **Volcker**. I think the budgetary process is a disciplining process and hopefully will be retained. That's a process, not a result.

Senator **Mattingly**. Thank you.

Thank you, Mr. Chairman.

The **Chairman**. We do have a vote. It's on a motion to instruct the sergeant at arms to establish a quorum and will then be immediately followed by the cloture petition. Senator Sasser is next. Do you want to come back, or do you want to question until we get the five lights? It's your choice.

Senator **Sasser**. Mr. Chairman, why don't I question until we get the five lights and maybe we can at least get my questioning period behind us.

### GOAL IS FOR A MODERATE, SUSTAINED RECOVERY

Mr. Chairman, you said a moment ago in response to a question from my friend, the distinguished Senator from Georgia, that you really shouldn't be advising us on fiscal policy.

Well, I disagree with you, because I think your counsel on fiscal policy to the Congress and to the administration can be very important.

In my view, one of the problems that we have now is that we have been operating our fiscal policy on one track and monetary policy on another track, and I think that has gone a long way toward putting us into the economic difficulty that we have encountered over the past 2 or 3 years. And I, for one, am delighted to get your views on the question of indexing because I have been long concerned about how you could index on the payout end with the entitlement programs, gear them into the Consumer Price Index and raise them, and on the same level, on the revenue end, index that. It appears to me that you're really burning the candle at both ends about indexing on revenues and payouts.

So I, for one, am glad to get your views on matters affecting fiscal policy.

You stated during your testimony last week before this committee that we were experiencing an average economic recovery, running, according to the figures I have, the first 6 months of this year at 4.6 percent, accelerating some now.

Now some disagree with that because the average of real GNP growth in all other postwar recoveries has been about 8.5 percent.

Mr. **Volcker**. I don't think that high for the first year of recovery; about 7 percent, as I recall.

Senator **Sasser**. We're talking about the first 6 months.

Mr. **Volcker**. The first 6 months? So much depends upon a particular quarter when you have a period of only 6 months.

Senator **Sasser**. I think we will agree that this recovery has been slower getting underway.

Mr. **Volcker**. The first quarter was slower than is typical. The second quarter, I think, was a very strong quarter and the third quarter is likely to be high, too.

Senator **Sasser**. You stated that $M_1$ will grow between 5 and 9 percent for the balance of this year and it's grown so far this year at the rate of about 14 percent—13.9 percent, I think would be more accurate.

Now what is this new monetary policy going to do to real GNP growth during the next several months? Can you make a strong case that this is going to reduce our real GNP growth?

Mr. **Volcker**. I would not call it a new monetary policy, but as I just said, I think we went into the third quarter with a good deal of momentum and I would expect a rather large GNP growth during the third quarter. I would also expect that thereafter it would probably slow down. It can't continue at that rate of speed and, on balance, in the interest of the sustainability of the recovery, it wouldn't be desirable to continue at the same rate of speed as the second quarter. That's fine for a quarter or two.

Senator **Sasser**. We've got a long way to go, I think, Mr. Chairman, to get back to where we were.

Mr. VOLCKER. We do, indeed, have a long way to go, and, if I may just make that point, I want to get there. I don't want to go very rapidly for a couple quarters and then get turned off. We are not going to make it in a couple of quarters. I want to be able to keep it on the long road.

Senator SASSER. Well, I want to stay on the long road, too, but I don't want to get overly euphoric because we've had a couple of good-looking quarters here.

Mr. VOLCKER. Neither do I.

Senator SASSER. Looking at the rate of business failures year-to-end June 30 this year compared to June 30 last year, we've got a 26-percent upkick in business failures; 1982, through June 30 of that year, 11,948 business failures; through June 30, 1983, 15,137. So I don't want to see us tighten this monetary policy down too quick, too fast, and abort this recovery.

You indicate in your monetary report—I quote from it—"The Federal Reserve Board, for its part, remains committed to monetary policy that will provide enough money and credit to support economic growth in the context of containing inflation."

Mr. Chairman, I question you as to what the Federal Reserve Board's target is for containing inflation. What is an acceptable rate of inflation that wouldn't trigger a further tightening of the money supply?

Mr. VOLCKER. I'll just give you a very personal view looked at over a much longer period of time than the horizons of this statement. I think we ought to get the inflation rate down to the point where we can say there isn't any inflation, basic stability. That doesn't mean no change in the price index in any particular year, particularly during a period of recovery; it means, whatever the precise statistics are, people should not be planning on inflation. They ought to be living in a context where they think the dollar is better and it's going to be stable, now and in the future, where they don't plan on price increases. I think that's healthy for the long-term growth of the economy.

We're not going to achieve that in the next few years.

Senator SASSER. That's an ideal world and I think both you and I would agree that we can't really manipulate monetary policy looking in the direction of hoping realistically for zero inflation, can we?

Mr. VOLCKER. Not in the next few years.

Senator SASSER. Well, we haven't been able to do that in the last 50 or 60, have we?

Mr. VOLCKER. We did it pretty well for a good many years in the 1960's. It wasn't bad in the 1950's. We had a little inflation in the 1950's, but not really enough to worry about, although we used to worry about it in the 1950's. That's when I began as an economist in the Federal Reserve. It went up to 2 or 3 percent at times and we worried about it. But the trend during the 1950's, on the average, was between 2 and 3 percent, maybe lower, and when it gets that low it begins to be hard to tell that there is any inflation, although that was on the edge of it. You get quality changes—the indexes aren't perfect, and all the rest. You might have stability in the wholesale price index which would be a pretty good indicator of no inflation. We haven't had any change in the wholesale price index now for the first half of this year, but that was at the bottom of the recession. If we could achieve that during a period of recovery, or on the average over the years, we'd be home free, but I recognize that having achieved that in the first 6 months of this year is not an indication that we are home free, because that was close to the bottom of a recession.

Senator SASSER. One quick final question, Mr. Chairman, if I may.

In a recent article, a Washington Post reporter, John Berry, reported that Dr. Martin Feldstein—I see him in the room here—who will testify later, believes that high real interest rates are already producing a "lopsided economic recovery" with interest-rate-sensitive and trade-oriented sectors of the economy facing much weaker growth than other sectors of the economy.

And we see now that home mortgage rates are once again punching up close to 14 percent, that homebuilding is starting to decline and fall off again, in the last numbers coming out the month of June.

Do the new monetary targets now announced by the Federal Reserve Board remedy this problem?

Mr. VOLCKER. No.

Senator SASSER. Are they concerned about that problem, Mr. Chairman?

Mr. VOLCKER. I have been one of those who has consistently and persistently and strongly pointed to the danger of overly large budget deficits and, as you point out, the danger of a lopsided recovery. That's the same message that I've been trying to give here, and it's nothing that can be cured by monetary policy.

The budget deficits—unless they're corrected—are going to take an extraordinary part of our savings. In the end, those same savings are needed to finance home building. If you're worried about home building, you ought to be at the beginning of the parade to do something about the budget deficit, because there's just a conflict in the market between extraordinarily large budget deficits and mortgage needs generated by a strong housing picture.

Senator SASSER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, I'm going to waive my questioning of Chairman Volcker to accommodate the chairman who otherwise would have to wait until we return from the vote. May I ask when will we vote on his nomination?

The CHAIRMAN. Well, I appreciate that because we will have this vote and another one, and I'd hate to hold the Chairman, but I would hope the committee would return immediately after the vote on cloture so we could hold our vote, and I will encourage all committee members to do that.

I will announce, because of the difficulties we have had on the floor, that we will have no additional witnesses this morning. Mr. Sprinkel, Mr. Blinder and Mr. Meigs will come back this afternoon at 2 o'clock and Mr. Feldstein will be rescheduled at 9:30 in the morning.

Thank you very much, Mr. Chairman. We appreciate your testimony today and hopefully we will have a recommendation on your nomination within an hour.

The committee will stand in recess for about 30 minutes.

[Whereupon, at 11:10 a.m., the hearing was recessed, to be recovened at 2 p.m., this same day.]

### AFTERNOON SESSION

Senator **Gorton**. The meeting will come to order.

We are delighted to have Martin Feldstein with us. As is generally the case, his entire statement will be included in the record as if read in full, and I understand he intends to give a brief version thereof.

Mr. Feldstein.

## STATEMENT OF MARTIN FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. **Feldstein**. Thank you very much, Senator. I am very pleased to be back here again.

When I appeared before this committee in February, the economic outlook was still very uncertain, but since then the economy has shifted into high gear and is now proceeding at a very satisfactory pace for this stage of the recovery. I thin'. there is every reason to believe, with the right policies, we could be at the beginning of a sustained expansion with a declining rate of inflation.

As you probably know, the Commerce Department this morning announced that GNP growth for the second quarter was a very fast annual rate of 8.7 percent. That brought the annual growth rate for the first half of the year to 5.6 percent. The growth spurt at that pace is a welcome indication that the recovery is on track. The growth at that speed is typical of this phase of the recovery.

The 8.7-percent growth was higher than the second quarter growth in three of the seven postwar recoveries and slower than the second quarter growth at the end of four of them.

Of course, the recent rate cannot be expected to continue for more than a few quarters. The administration projects real growth in 1984 will be 4½ percent, followed by 4 percent annual rates through 1988.

Although there is significant uncertainty about the forecast for individual years, with appropriate economic policy it should be possible to achieve an average growth rate above 4 percent for the next 5 years.

I should emphasize, however, that our projections assume that Congress will enact the President's budget, thereby providing an unambiguous assurance that budget deficits will be declining rapidly in the second half of this decade. If such a budget is not enacted in the next few months, real interest rates are likely to remain high or rise further, significantly reducing the chance of the healthy and balanced recovery.

One of the most gratifying aspects of the past half-year has been the remarkable price stability. The level of consumer prices in May was only 1 percent above the level of 6 months earlier.

### RISING INTEREST RATES AND INFLATION

The very good news about inflation is no excuse for complacency. Inflation will stay under control only if we keep it a high priority of Government policy. The inflation rate has often been relatively low during the first year of an economic recovery but has then risen substantially in the years ahead.

Thus, the inflation rate rose from 0.7 of 1 percent in 1961 to 6.1 percent in 1969. Inflation then started the next recovery at 3.4 percent in 1971 and rose to 8.8 percent 2 years later.

During the expansion that began in 1975, the inflation rate almost doubled, rising from 7 percent to more than 13 percent.

Experience shows that the rate of inflation rises when the level of demand is too high or when it is rising too fast. Once inflation starts to rise, expectations begin to change, and the anticipation of further increases in inflation make it that much more difficult to reduce the rate of inflation.

So despite the remarkable success of reducing inflation since 1980, it is particularly important to remain vigilant and to prevent any rekindling of the inflationary spiral.

The principal problem facing our economy at the current time is the high, rising level of real interest rates. These high interest rates are hurting key sectors of the economy, have raised the international value of the dollar to an unprecedentedly high level, and are generating calls for monetary policies that, if pursued, will cause rising rates and inflation.

Let me comment briefly on each of these points.

As you know, interest rates have been rising sharply for the past 10 weeks. The interest rate on Treasury bills is now over 9 percent, a full percentage point higher than at the beginning of May.

Long-term Treasury bonds have also risen more than a percentage point. Other market rates have moved up in parallel.

Short rates have not been as high as they are now since last summer, and all rates have not been as high since last fall.

The increase in short-term market interest rates is likely to cause banks to raise their prime lending rate almost any time. The prime is now 10½ percent, but it is usually about 2½ percentage points above the Treasury bill rate, and since the Treasury bill rate is now 9 percent, the prime by that traditional historic standard would be about 11½ percent.

Moreover, the basic cost of incremental funds for the banks, as measured by the rate on large CD's has increased about a percent and a half since the banks lowered their prime from 11 to 10½ percent.

Real interest rates are abnormally high for this stage of the recovery. During the first year of the past six recoveries, the real interest rate on Treasury bills was never as high as 2 percent. At present the real Treasury bill rate is at least 5 percent.

Since it is the real interest rates on short-term and long-term securities that keep the exchange value of the dollar high and cause problems for interest-sensitive industries, the current high real rates are a cause for serious concern. The high real interest rate on long-term bonds has caused the dollar to rise about 40 percent since 1980 relative to the other major currencies, even after adjusting for differences in inflation.

The strong dollar has caused a decline in exports and a rise in imports that is likely to result in a record merchandise trade deficit this year of more than $60 billion. By next year there is a substantial risk that the trade deficit will be more than $100 billion.

The high real interest rates are also reducing the pace of activity in a number of key interest-sensitive sectors. For example, while capacity utilization rates in industries like food and textiles, that are not particularly interest sensitive, are essentially back to their 1980 levels, the capacity utilization rates in an interest-sensitive industry like iron, steel, or machinery are still very much below the 1980 levels.

It will, of course, be next year, the second year of the recovery, that the behavior of interest-sensitive sectors of the economy will be particularly important. The first year of the recovery is helped by the turnaround in inventory accumulation and the rise of consumer spending.

Experience shows that the GNP growth rate in the second year of recovery typically slowed substantially from the first year's growth. By the second year of the recovery the inventory turnaround is essentially complete, and an expansion of the usually interest-sensitive sectors has to play a larger role.

The fundamental reason for the high level of real interest rates is the widespread expectation of large budget deficits for the remainder of the decade. Despite the recent increase in the projected rate of economic growth, budget deficits are likely to remain in the $150 billion to $250 billion range unless legislative action is taken.

It is sad but true that increases in the rate of growth reduce deficits by amounts that are very small relative to projected deficits. A full 1-percent increase in the GNP reduces the deficit by less than $15 billion.

Budget deficits of $150 to $200 billion would absorb funds equal to between one-half and two-thirds of the net private savings of households, businesses, and State and local governments. To reduce the borrowing demand of private investors and households to remain relatively small would inevitably require high real interest rates.

Despite the fundamental importance of the projected budget deficits as determinants of the existing level of real interest rates, much of the day-to-day public discussion of interest rates focuses on the Federal Reserve. Perhaps that is only natural. The Federal Reserve does affect interest rates, and the seemingly mysterious nature of open market operations is a natural subject for speculation, since the financial markets are aware of the Federal Reserve's monetary targets. Any unintended increase in one of the monetary aggregates induces expectations of further Federal Reserve tightening and therefore immediately raises interest rates.

It is important, however, to recognize that the fundamental equilibrium of real interest rate reflects the basic supply and demand for funds in the economy. If the Goverment increases its demand for funds, the real interest rate will rise. If individuals want to save more, the real interest rate will fall.

Although the Federal Reserve could temporarily lower short-term interest rates by explicitly adopting a policy of rapid expansion of the money stock, this would subsequently lead to higher rates of inflation and higher market rates of interest. As long as the Federal Reserve follows a prudent monetary policy that avoids raising the future inflation rate, large outyear deficits will inevitably mean high real interest rates.

### MONEY GROWTH RATE MUST BE DECREASED

Experience shows that faster money growth leads to higher inflation and higher interest rates. Although the relationship with money, inflation, and interest rates is complex, the essence of the relationship can be illustrated by comparing 5-year averages from the first half of the 1960's to the last half of the 1970's.

That is what I have put on the table on page 11, which shows that when one goes from one 5-year period to the next, the growth rate of money increases 5-year period after 5-year period; the inflationary increases 5-year period after 5-year period; and the Treasury bill rate is pulled up with it, although any notion that a sustained increase in money growth rates can cause a sustained decline in interest rates is contrary to both experience and economic theory.

Although no one can like the high real interest rates they see today, it would be a mistake for the Federal Reserve to pursue an expansionary monetary policy aimed at reducing those rates.

The effect of such a policy would be an ineluctable resurgence of inflation and a new rise in market rates of interest. Only by reducing the growth of $M_1$ can the interest rate be reduced.

The appropriate aim of monetary policy should instead be to provide enough money and credit to permit continuation of real growth with stable or declining inflation.

For 1984, for example, the administration forecast projects 4½-percent growth in real GNP and a 5-percent rise in prices, as measured by the GNP inflator. These two figures imply that nominal GNP will rise 9.7 percent. A faster rate of growth of nominal GNP would be expected to result in both a higher rate of real GNP growth and a higher rate of inflation.

The historic experience indicates that nominal GNP rises about 3 percent faster each year than the stock of $M_1$. That is, individuals and businesses have on average reduced their use of $M_1$ per dollar of GNP at a 3-percent annual rate. This suggests that an $M_1$ growth rate of about 7 percent would be compatible with the nominal GNP growth forecast by the administration.

Although an $M_1$ growth rate of 7 percent is in the middle of the newly announced Federal Reserve target range for $M_1$, it is very much below the actual growth rate of $M_1$ during the past several months. In the 3 months from March to June, $M_1$ grew at a rate of 12 percent.

If the historic trend and philosophy prevails, persistence of $M_1$ growth at 12 percent would lead to a nominal GNP growth of 15 percent, or about 5 percentage points higher than the administration is forecasting. This would undoubtedly mean inflation rates substantially greater than the 5 percent we have forecast, probably inflation rates as high as 7 to 10 percent by 1984–85.

It is for this reason that the growth of $M_1$ must be slowed. It is, of course, always possible that institutional changes or other factures are causing a decline in the $M_1$ philosophy, implying that the current $M_1$ growth is not excessive.

Last fall and winter, I repeatedly defended the Federal Reserve's policy of allowing $M_1$ to grow rapidly in the second half of 1982 and explained at that time that the apparently rapid growth was in fact just a one-time level adjustment in the stock of money that would permit interest rates to adjust to the lower level of inflation that had already been achieved.

Similarly in the first quarter of this year, the introduction of the super NOW accounts, the money market deposit accounts, made the interpretation of changes in $M_1$ so uncertain that criticism of the 17-percent $M_1$ growth would, I think, have been inappropriate.

Although it is possible that the $M_1$ growth figures are still being distorted by the regulatory changes earlier this year, a detailed examination of the individual components of $M_1$ provides no real support for that view.

Money targets must, of course, never become ends in themselves. They must be understood as a way of achieving an appropriate long-run path for the economy. If sustained experience shows that the money targets are not compatible with the desired level of GNP growth, then the money targets themselves must eventually be recalibrated.

But in the absence of clear evidence of a velocity change or reasons to believe that a shift of money demand has occurred, a money growth target based on the past velocity periods is an appropriate basis for guiding the monetary aggregates.

I think that is what Chairman Volcker said this morning in answer to one of the questions, and while it would be wrong to worry very much about 1 or 2 months of abnormal money growth, a persistent rate of growth that is roughly twice a suitable target value is unacceptable and should be decreased.

I think that the Federal Reserve policy announced yesterday and then again here this morning by Paul Volcker, of bringing the $M_1$ growth rate down to the 5- to 9-percent range for the remainder of the year is appropriate. It is now very important to bring the actual $M_1$ growth rate down into this range.

Short-term interest rates have risen in anticipation of such a policy aimed at slowing the growth of $M_1$. Further increases in interest rates may continue in the months ahead. It is, of course, impossible to know how much further, if at all, interest rates must rise in order to bring $M_1$ growth back to an acceptable rate.

The financial future markets and the interest rates on 1- and 2-year bonds indicate clearly that financial investors expect short-term rates to continue rising. While no one likes to see interest rates rise, an increase in interest rates over the next few months would be far better than a continuing surge of money growth that led by 1984 or 1985 to a revival of rapid inflation followed by another economic downturn.

I don't mean to imply by that that I think that such an increase in interest rates makes it inevitable. It may, indeed, fall for other reasons, but if there is an upward pressure it would be a mistake to try to offset it by an explicit shift away from the Fed's $M_1$ target.

### SPENDING CUTS AND ADDITIONAL TAX REVENUE

Although the focus of these hearings is on monetary policy, I cannot conclude without returning to the problem of budget deficits. Budget deficits of the magnitude that may prevail in the years ahead would do very substantial harm to the American economy. The lower rate of capital formation would hurt production, decrease growth, limit the rise in real incomes, and weaken our international competitiveness.

In the near term, large anticipated budget deficits and the high real interest rates that they cause make the recovery unbalanced and therefore inherently more fragile. The prospect of large budget deficits very much complicates the task of monetary policy.

The budget that the President submitted to Congress earlier this year recognizes the importance of reducing the deficit and proposes legislative action to shrink the deficit to about 2 percent of GNP by 1987-88 as a result of domestic spending cuts and revenue increases.

The share of GNP devoted to domestic spending by the Federal Government has doubled since 1960, rising from 8 percent to 16 percent. Shrinking that share is essential if we are to avoid perpetual deficits or unacceptable tax increases.

Spending cuts must also be accompanied by additional tax revenue. Ideally, the extra revenue will be forthcoming without a rise in tax rates because economic growth substantially exceeds our forecast. But if this does not occur, the President's budget calls for an increase in tax rates that begins in October 1985—a 5-percent surcharge on personal and corporate tax payments and a $5-a-barrel tax on imported and domestic oil, contrary to what some people are apparently telling the press behind the veil of anonymity.

The administration remains firmly committed to these standby tax increases and to the budget of which they are so vital a part.

Two aspects of the administration's tax proposal should be noted. First, there should be no increase in tax rates in either this year or next while the recovery is still getting established.

Second, the subsequent additional tax increase should be enacted this year in order to reassure financial markets and other investors that the deficits will indeed be shrinking. The resulting change in projected deficits would permit an immediate decline in long-term interest rates and a favorable judgment of the exchange value of the dollar.

The combination of spending restraint and the enactment this fall of such tax legislation would provide the much needed evidence that budget deficits will indeed begin to decline sharply after the recovery is firmly established, and that evidence would be the key to a sound and healthy recovery in the months and years ahead.

### NEW YORK TIMES STORY ERRONEOUS

Senator GORTON. Mr. Feldstein, are you telling us that the story in the New York Times this morning is in error?

Mr. **Feldstein**. Yes. I am telling you exactly what I said, that the administration remains firmly committed to standby tax increases and to a budget of which they are so vitally a part.

I can't remember exactly what the story said. I remember vividly that the headline said just about the opposite of this, and the headline was clearly wrong. I would have to go back to read the story to comment on the story.

Senator **Gorton**. I will read the first paragraph of the story to you.

> The Reagan administration, according to several officials, has quietly dropped the President's contingency tax plan the President wanted enacted this year so the tax will automatically go into effect in late 1985.

Mr. **Feldstein**. There is no dropping of the standby tax. There is, if anything, a reaffirmation that the standby tax, as part of the whole budget proposal, is still very much alive in our minds.

Senator **Riegle**. Would the Senator yield so I can ask one question on that one point?

Senator **Gorton**. Go ahead.

Senator **Riegle**. I thank you for yielding.

I think it is important what you are saying here now. The problem is the television cameras that were here this morning, and Chairman Volcker disappeared.

But if that is the case, if what you are saying represents not just your view but the President's view, I would just say to you that it is essential that he say so publicly, and until such time as he affirms that in the most clear-cut Reaganesque language as he is fully capable of doing, I don't think what you are saying is going to be believed because the New York Times is not going to run off front page stories citing unnamed several officials within the administration unless, in fact, they are hearing that from the officials within the administration, and we are getting different signals from other people publicly.

Don Regan is saying things that don't exactly square with what I hear you saying now. I feel that maybe he is the chief spokesman, or you, for the President.

Somebody has that title presumably, but I just want to say to you unless the President says that forcefully and follows it up with action coming out of the administration to the Members of the House and the Senate that are involved here—your saying it, quite frankly, is not going to carry the weight it needs to carry.

Mr. **Feldstein**. My impression is that this question was going to arise in the usual daily press briefing. Then White House spokesman, Larry Speakes, would confirm that there is no move away from the original proposals.

Senator **Gorton**. I would have to say that there is a great deal of merit to Senator Riegle's comment.

For example, the same story here, a couple of paragraphs later on, goes on to report the reaction to these unnamed administration officials of Chairman Rostenkowski of the House Ways and Means Committee, who said, well, if this is the case he is not going to go ahead in that committee with an attempt to comply with the first budget resolution.

My own comment would have to be that I would regard that as an irresponsible response to an irresponsible change in the administration position if, in fact, the administration had changed its position.

Mr. Rostenkowski, a few months ago, supported the Democratic budget proposal in the House of Representatives which calls for considerably larger tax increases than those eventually passed in the first budget resolution. If, as he clearly states here, he regards the first budget resolution as a responsible course of action, as we do here in the Senate, it would seem to me a dereliction of our own duties to react to one mistake in policy by following a mistake in policy of our own.

I am delighted at your rather forceful restatement of what has been administration policy since January. I certainly hope that the best and most eloquent possible spokesman—without any criticism, obviously, of you—that the highest possible language.

Mr. FELDSTEIN. I think what the Times story indicated is that there is a growing fear that the spending cuts that the President proposed as part of the same budget were not moving ahead.

Senator GORTON. That is a valid criticism. I know, on the other hand, that the chairman of the Senate Finance Committee, Senator Dole, believes very strongly that increases should be accompanied by spending cuts beyond those proposed in the first budget resolution. Of course, nothing in the first budget resolution prohibits that kind of action, but they are obviously impossible without support, for the very minimum, the revenue increases which the President recommended in January.

If I can, I will go on to a related question.

### MODERATE GROWTH IS SAFEST POLICY

Chairman Volcker suggested this morning that, with all due allowance for uncertainties, $50 billion of deficit reduction would translate into interest rates being 1 percentage point or perhaps a little bit more lower than what otherwise would be the case.

Do you agree with that proposition?

Mr. FELDSTEIN. It is very hard to put a specific number on it. That didn't strike me as an unreasonable number. I think he was careful to say that it depends upon what people thought was coming next. I think the passage of something like the administration's budget, with the substantial reductions that implies year after year, could easily cause long-term real rates to decline by a full percentage point.

Senator GORTON. By the same token, the failure to abide by the structures of the budget resolution or of that budget would have a correspondingly negative impact, I would assume?

Mr. FELDSTEIN. It is not clear how much the financial markets have already given up on Washington for dealing with this problem. They have already given up all hope, and the bad news is here.

I think there is some glimmer of hope left in the financial community that we are going to find a way of dealing with this problem.

Senator **Gorton**. I would like you to look at page 14 of your statement. I would like your answer to perhaps an even more fundamental question.

In the first full paragraph on that page you deal with the relationship between the growth in $M_1$ and the growth in both nominal and real GNP and inflation. Is the implication of what you say there that we can choose between relatively low inflation and a modest growth in real gross national product. Say 4½ percent per year, or that we can have higher real growth in the economy by paying for it with higher inflation in the range of 7 to 10 percent? Is that a choice which we have, which you are simply making the moral or ethical statement that the former of those is preferable? Or is that not really a choice, except for a short period of time?

Mr. **Feldstein**. In the short run, for a year, if we pursued a monetary policy that produced a higher nominal GNP growth by say 5 percentage points, some of that would show up in a higher rate growth and some of that would show up in inflation. If we continue to pursue that higher nominal GNP growth for another year or two, all of the real growth effects would probably be gone and we'd simply find ourselves with a 5-percent higher inflation.

There is a little bit of shortrun trade off, but only a shortrun possibility, and even that no one can be very precise about.

Senator **Gorton**. I want to make very, very certain that you are not telling me, the President, or the Congress of the United States, that we can exchange, that we can have a higher rate of growth, real growth than would otherwise be the case, by paying for it with a somewhat higher rate of inflation, and sustain that condition over any but the shortest period of time.

Mr. **Feldstein**. That is correct. You cannot have a sustained higher rate of real growth at the price of taking more inflation. You can only, at best, affect it in a temporary way.

Senator **Gorton**. Are you saying, by the same token, the prescription of monetary growth which you outline here is likely to result, as we look at a 2- or 3- or a 4-year period, in a total of more real growth in the economy than would be the case with a much higher rate, a significant higher rate of inflation?

Mr. **Feldstein**. I think the danger of a significantly higher rate of money growth and inflation is that at some point, we would be back in a situation where to stop that inflation, we would see the monetary authorities putting their foot on the brake, and that would send us down into another recession that would leave us with a lower level of real growth than if we had pursued a more moderate course.

Senator **Gorton**. Let's take the potential alternative. It's not even tied to this administration. Let's say the Federal Reserve had not stepped on the brakes. What would have been the result under those circumstances? Could we have continued to grow simply at the expense of double-load, double-digit inflation?

Mr. **Feldstein**. I think at a certain point the economy could not take an inflation rate that had gone from 7 percent to 12 or 13 percent in 5 years and might go on moving up to higher and higher rates. The distortions and losses resulting from that would be intolerable. It is only a question of when, not whether we were going to have that kind of turnaround.

Senator **Gorton**. And a nation that follows that course of action turns inevitably into a Brazil or a Mexico?

Mr. **Feldstein**. If it keeps getting higher and higher, yes, you can get to the 120-percent inflation rate we were seeing in Brazil.

Senator **Gorton**. I will defer to Senator Riegle.

Senator **Riegle**. I think the Chairman is raising an important issue. We could spend a lot of time on all of this. I think if one goes back and takes apart the inflation surge that we're dealing with, in which the Fed responded with a very tough policy, basically, to shut the economy down for all practical purposes, and we went into a major extended recession, which we are just beginning to come out of—I'm not here to argue for inflation. I'd prefer to argue against inflation, but there are certain factors that drove that inflation. Oil prices were one. We were sort of digesting those conditions. Others are fundamental shots of upward price levels that were then working themselves through the price-wage adjustments, and so forth.

I suppose one never knows, unless one plays it out, whether all of that keeps pyramiding and eventually you end up looking like a Brazil or somebody else. At some point those things work their way on through, and then if you don't have more fundamental upward price shocks, you level out at a new level and go on from there and we don't have these rapid bursts.

I simply make the point that I am not confident that we know one way or the other. We're just in the process now of adjusting the $M_1$ targets. In so doing, we are inflating the base with the 14-percent growth rate.

So we are talking about a new target in the 4- to 8-percent range, or I should say 5 to 9 percent range, which is actually increasing the levels, but by consolidating the recent bursts of the base, to go back to the old base, it's 11½ percent. Well, that's a bigger story, with bigger implications than if one says it's 5 to 9 percent.

I want to come back to the inflation thing later, but I think there are some really critical issues that we have to try to deal with, and the Chairman, I think, has opened one up here on the question of a tax issue, and the matter of taking and putting all of the components of macroeconomic policy together in the right mixture so we get the things we want: sustained growth, low inflation, and unemployment, and so forth.

Senator Gorton has worked as hard as anybody in the Senate to try to help maintain budget discipline. And others on the committee, including myself, have worked with him, and we've managed, to a degree at least, to keep the budget discipline alive only by a one-vote margin in the Senate on a bipartisan basis.

Let me ask you this question. I'm concerned that this whole thing may very well fly apart here, despite everybody's best intentions, including your own.

### CONSEQUENCES IF ADJUSTMENTS NOT MADE

As I read your statement, which you wrote very carefully and is conditioned carefully, it is based on the assumption that we're going to get both the spending cuts asked for and the revenue increases. In other words, if we can get what you ask for, you make a case that the thing will work.

The problem is all the evidence that's piling up indicates that as of today we're unlikely to get either. We're not going to get the spending debts either in the amount or the areas asked for, and there is a very real question as to whether we're going to get into tax increases.

And so I would just ask you this question, and that is, let's say we don't, let's say that we get nothing close to the spending cuts envisioned or sought and say we don't get tax increases, standby or otherwise, and then you have to sort of go through and run the calculation again, what would your outlook be then?

Mr. **FELDSTEIN**. I think there are two things I want to emphasize. The first is that would very much affect the kind of recovery we have with housing, plant equipment, trading goods sectors, all significantly depressed relative to what they would otherwise be.

Senator **RIEGLE**. That's because interest rates would go up.

Mr. **FELDSTEIN**. Interest rates and the cost of capital somehow have to be higher; crowding out has to occur. With the Government's borrowing $150 to $250 billion, 5 percent of GNP against a net savings rate of 7, a gross savings rate of 16, there's a displacement.

Senator **RIEGLE**. Long-term private investments are presumably the ones that are hardest hit.

Mr. **FELDSTEIN**. They will be crowded out. The exchange rate, as we've already seen, will move to draw in funds from abroad and that will have very serious effects on all kinds of American industry, very serious effects.

The second aspect is what this does to the viability of the whole recovery, and that's a big question mark. We've never run a recovery with real interest rates at the levels we now have.

As I said in the prepared statement, we have real interest rates of about 5 percent now for short-term Treasury bills. They have been negative in several of the recoveries in the first year.

The trade deficit clearly puts pressure on critical sectors of the economy. So I think that we run a substantial risk. That is not to say it's going to happen, but the risk is much more substantial than I think it should be. A risk, the recovery will not make it through next year or the year after, if we don't deal with these deficits, and that really means we are sure of financial markets of not just 1 year, but several years of continually declining deficits.

Senator **RIEGLE**. I tend to agree with what you said. My own assessment is the risk is a substantial risk, if we work the right basis in place here. Let me tell you what my concern is from sitting on this side of the table.

Very often in the last year-and-a-half approaching a Presidential election, a kind of paralysis sets in. The tough question is nobody wants to cut spending very much, nobody wants to raise taxes very much. So what happens is, things just start to freeze into place. Major things tend to get postponed, and then time just runs and what I've just heard you say sounds to me like in the next 1½ years, if not the next few months, is really critical in making the policy adjustments needed to keep us on track.

Mr. **Feldstein**. That's right.

Senator **Riegle**. The thing that concerns me now is that I'm hearing talk from colleagues, and I hear some on both sides of the aisle, to the extent that maybe this whole thing now is sort of self-erecting. In other words, we've really sort of taken all the actions we need to. The stock market shows a lot of lift, not just yesterday, but over a period of time, and that the recovery itself will solve all these problems for us. Even the Treasury Secretary is now saying that he thinks there is going to be sort of a revenue bonus coming—my phrase, not his—and speaking about coming off the recovery and really eat into this deficit.

I'm frank to say I don't see much of that.

Mr. **Feldstein**. As I said in the prepared statement, an extra 1 percent in the level of GNP is worth about $15 billion. That is not a trivial matter, even these days, but we are comparing it to $150 to $200 billion worth of deficit. So it helps.

Senator **Gorton**. You're not going to get a 12-percent GNP increase.

Senator **Riegle**. I guess what I'm getting to is this. I think we're after some of the same things in terms of the outcomes we would like to see and the stakes are awfully high, because in the end it gets paid for, not by who gets elected, that's part of it, by who gets hurt, the people who are caught on the far end of this lose their jobs, their businesses, whatever.

Mr. **Feldstein**. I continue to believe there's not as much of a difference in substance between the different players in this as readers of the newspaper might think. Look at the administration's budget. Look at the congressional budget resolution. They are important differences. They both agree that there has to be significant revenues started up within the 3-year program and fiscal year 1986 is where most of the money is. They both agree that domestic spending has to be reduced below the current services level. And that's in the budget resolution, as well as in the administration budget.

Senator **Riegle**. Let me put it to you this way. I would say today the odds are, I would say, about 85–15 that you're not going to see these major policy actions in your plan taken on the spending cut side or on the revenue side.

I just don't see events moving that way. They seem to be moving the other way. Like just a change in withholding of interest and dividends has revenue impact. There are others that are occurring like defense. So you kick things up on the expenditures side. We just voted on that just this week. All the hard evidence that one can see suggests that we're not going to make these adjustments.

My question to you is, should they not be made, rather than this set of outcomes based on the assumption that they are made, what is your assessment of what's likely to happen if, in fact, we're on those other kind of trend lines and these actions are not taken?

Mr. **Feldstein**. It depends on the rise we're looking at. We're looking at over the next year through 1984——

Senator **Riegle**. Let's take it over that period, say, through 1985.

Mr. **Fedldstein**. Let's look at the next 2 years to the middle of 1985. The most likely thing is that we will continue to have a recovery. It will be what I call a lopsided recovery in which key industries are hurt, interest sensitive industries, export industries, but we will muddle through. We will have a smaller capital stock when we finish. We will have destroyed some firms along the way. We will have hurt our international position, but we will muddle through. But there is risk, which I think is less than a 50-percent chance, but a sizable risk, that we won't make it through the next 2 years in this way, and that the distortions that were built into the recovery may cause it to fail.

The alternative risk that we face is that we will see interest rates continue to move up, and there will be overwhelming pressure to do something about those rates.

I think the Fed is basically committed to not allowing an inflationary course to develop, but I don't know what would happen under the wrong kinds of pressures from Congress to accommodate or offset those higher interest rates, and we could then find ourselves moving into a period in which we lose the gains that we've made on inflation, although I think we're running a very grave risk in moving down this path.

Senator **Reigle**. My time is up.

### DEPRECIATION OF DOLLAR AND INCREASED SAVINGS

Senator **Gorton**. A few moments ago, you made a statement that the value of the dollar keeps getting built up in international markets by capital inflows which respond to our high interest rates. Obviously, on the trade side, this puts us at a significant competitive disadvantage.

Other than that general proposition, can you estimate with any degree of precision the sensitivity of the value of the dollar to, say, 1 or 2 point fluctuations in interest rates around, above or below the current level? For example, can you estimate how much our balance of trade might be improved by a drop in the value of the dollar at any given level?

Mr. **Feldstein**. We do have staff estimates of those numbers. I could get for you after this hearing an indication of what those numbers are. I would add quickly, that there are a lot of problems with trying to estimate import, even more so, export demand relation, but I can supply you with the rest of it. It is clear that we didn't go from a current account surplus 2 years ago to a large current account deficit by accident. And the principal reason for it is this appreciation of the dollar.

Senator **Gorton**. We would appreciate your doing so.

[Information supplied for the record can be found on p. 114.]

Senator **Gorton**. On another subject, in the shorter run to stimulate the economy or to increase employment I would see a need to increase the level of savings in the economy both to finance the growing government debt and a higher level of capital accumulation.

Generally speaking, we focus on this from the point of view of tax policy, but is there a monetary policy in fact, a monetary policy that could be used to encourage capital accumulation?

Mr. **Feldstein**. I think not in this sense we were talking about monetary policy until now, except perhaps to the extent that higher rates of interest have a postive effect on savings. The lawyer definition of monetary policy, including some deregulation, which allows small savers to get higher rates of interest at any market level, allowing them to share in these interest rates, I think, has a long-term positive effect. It is clear that the principal ways of effecting savings are not in monetary policy.

Senator **Gorton**. Thank you.

Senator Reigle?

Senator **Reigle**. Yes, sir, I do.

### CONGRESS AND PRESIDENT MUST GET PROPER FISCAL MIX

Let me just cover a couple of things here along the same lines. I want to see us work this out. I want to see us work it out before this political paralysis overtakes us all and we do not get the right policy mix into place, because the very sectors that you say are going to take the pounding is where I happen to come from, and we have been pounded. I do not think we can take another pounding.

We have lost an enormous number of companies, and there is a lot of shrinkage, but for those that have survived it does not necessarily mean that they could survive another death march.

What worries me here—the analogy is the fiscal policy where we have had our foot on the accelerator and going full blast for the last several years here, and then we had our foot on the brakes on monetary policy in an extreme way, which helped take interest rates up so high that the economy started to shutdown in a major way, in fact, worldwide. We came very close to the edge of a catastrophic sort of shutdown.

It seems to me that what we have been witnessing in the last 2 months is we still have our foot down on the accelerator, the floorboards on our fiscal policy, as measured by the deficits. And on the other hand, we are now seeing the Fed seeing the first signs of things overheating, so they are now starting to ease their foot down on the brakes, and they say we are not going to go down very much; we just sort of want to lightly depress the brakes here and we hope this gives the right signals and so forth and so on and cool things off.

The thing that worries me is that if we continue with our foot on the accelerator over here on fiscal policy, I think we are kidding ourselves to believe that a few light touches on our monetary policy can do it.

I think all the other things we have talked about here make that unlikely. Those deficits, at $200 billion-plus rates, as they roll along and accumulate will undo us. They will throw us back into a condition like we had before.

You made a comment a few minutes ago to the effect that we would then run the risk of losing everything we have gained. All the travail we have been through to make some gains would, in fact, evaporate, and it would all be for naught. Let us hope that does not happen.

I guess my appeal to you is this; that is, I think the only way we are going to avoid that happening is we really need an honest-to-

God package deal. That is what we sort of did in the Budget Committee; we got some domestic spending restraints, and we cut the defense increase back. There was a lot of squealing and squawking in some quarters, but that was the judgment of Congress.

I would think at this point, unless it is very strongly your view—you do not have to agree with the exact mix, but the fact that we have to have a mix gives us the same bottom line—if that is your view, it seems to me you are going to have to use every muscle and your persuasive power and leverage at your command to help bring that about.

It seems to me that the President himself will have to become convinced that that is the case. I have no way of knowing whether he is or is not. Frankly, he is not extremely visible on this question right now.

My thought to you would be this, and that is, I think the window is closing on us here to try to do this, and we cannot possibly do it without him. We need him not just as a passive player, but he has really got to get deeply and actively involved, presumably because he is convinced that that needs to be done.

I do not know if you can get the convincing done or not, but if you cannot and we cannot get him involved with people like myself and Senator Gorton and others on both sides of the aisle who are willing to try to stretch and meet and work the thing out, it is not going to happen. If it does not happen, it seems to me we are going to miss a chance we all had to try to do it.

My hope would be that you would think about that and see if there is not some way that we could try to trigger a whole new effort and emphasis within the administration with the President himself along these lines, because I think if he were willing to be a major force in leading this effort, I think we could get it done. If he is not an active leader in that respect, I think it is almost a certainty that it will not be done.

Mr. **Feldstein**. Let me repeat again I have no doubt about it in my own mind that the President would still be very pleased to see the outcome of the package that he has proposed in February with the standby tax. But I think that is only part of the package, and we should also see a set of reductions in domestic spending.

The difference between the congressional budget resolution and the administration's position is not, I think, an original one. But I think there is no indication coming from the Congress. As you said yourself, there is a willingness to make some of those tough spending cuts, but the difference is on the order of about 3 percent of domestic outlays.

If there was a clear indication that Congress was prepared to make those additional cuts, to go a little bit beyond what the congressional budget resolution lays down, then I think you would be at the levels of spending and would be in a position where the standby tax could be fully supported by the administration.

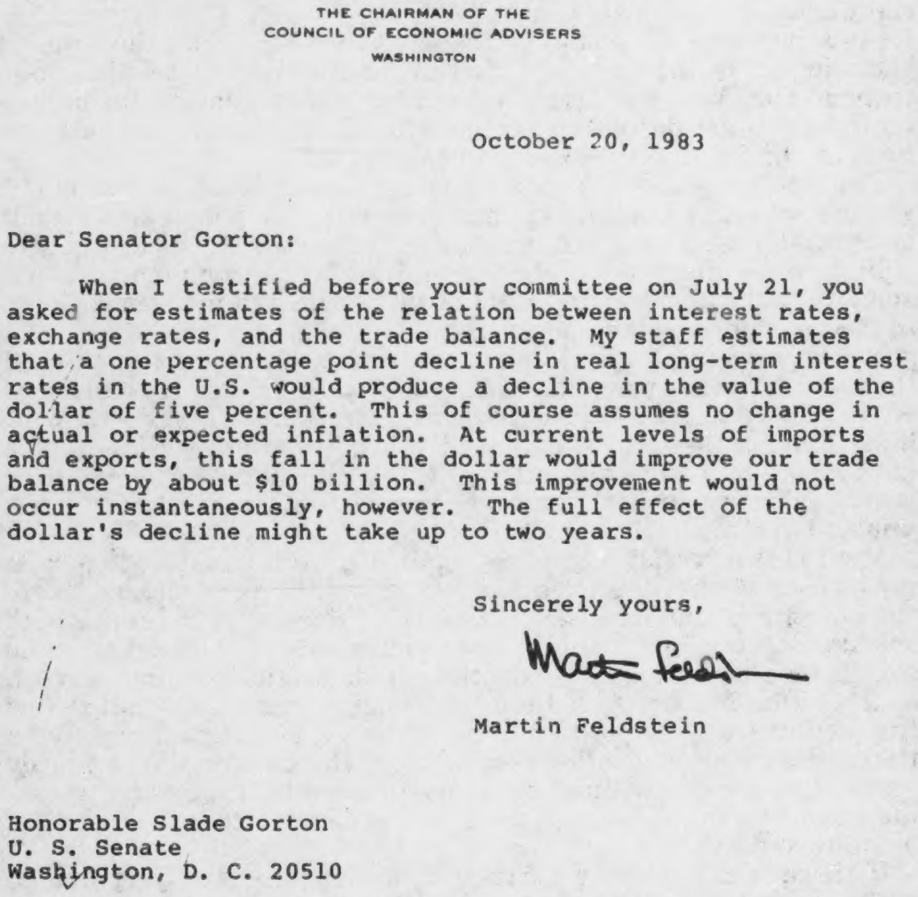
Senator **Riegle**. I think if we put together a package that would involve working out some understanding on domestic spending cuts, including something on entitlements, something in the revenue area, which presumes nobody is going to get everything they want, including the President, something on defense—you need the package, you need to package it in the end, because if you do not get all the pieces you do not get the total, so you cannot just take part of it because you cannot just get part of it. You have to have all the parts to get any of the parts, and you have got to have all the parts together to get the total and the bottom line to get the deficit reduction.

I think it is possible, but I really believe this window is shutting on us awfully fast here. I would like to see us get through the window before it shuts. I hope that is helpful to you.

Mr. **Feldstein**. Thank you.

Senator **Gorton**. Thank you very much.

RESPONSE TO SENATOR GORTON'S QUESTION



THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

October 20, 1983

Dear Senator Gorton:

When I testified before your committee on July 21, you asked for estimates of the relation between interest rates, exchange rates, and the trade balance. My staff estimates that a one percentage point decline in real long-term interest rates in the U.S. would produce a decline in the value of the dollar of five percent. This of course assumes no change in actual or expected inflation. At current levels of imports and exports, this fall in the dollar would improve our trade balance by about $10 billion. This improvement would not occur instantaneously, however. The full effect of the dollar's decline might take up to two years.

Sincerely yours,

Martin Feldstein

Honorable Slade Gorton
U. S. Senate
Washington, D. C. 20510

THE COMPLETE STATEMENT FOLLOWS

# Inflation, Monetary Policy and Budget Deficits

Martin Feldstein*

Thank you, Mr. Chairman. I am very pleased to be back with this distinguished Committee again.

When I appeared before this Committee in February the economic outlook was still very uncertain. Since then, the economy has shifted into high gear and is now proceeding at a very satisfactory pace for this stage of the recovery. There is every reason to believe that, with the right policies, we could be at the beginning of a sustained expansion with a declining rate of inflation.

I know that there is no need for me to review here the recent favorable experience with employment, production, income and sales. On the basis of that experience, the Administration in June revised up our projections for real economic growth. We now project a real growth rate of 5.5 percent from the final quarter of last year to the final quarter of 1983. Based on the revised estimate of a ________ percent growth rate in the first two quarters of this year (released this morning by the Commerce Department), our forecast implies real growth in the second half of the year at a _____ percent annual rate.

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*Chairman, Council of Economic Advisers. Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, July 21, 1983.

We also project that the real growth rate for 1984 will be 4.5 percent, followed by 4 percent annual rates through 1988. Although there is, of course, significant uncertainty about the forecasts for individual years, with appropriate economic policy it should be possible to achieve an average growth rate above 4 percent for the next five years.

I should emphasize, however, that our projections assume that Congress will enact the President's budget, thereby providing an unambiguous assurance that budget deficits will be declining rapidly in the second half of this decade. If such a budget is not enacted in the next few months, real interest rates are likely to remain high or rise further, significantly reducing the chance of a healthy and balanced recovery. I shall return to the deficit problem later in my testimony. First, however, I want to comment on the current inflation situation and the prospects for keeping inflation down in the future.

## Inflation

One of the most gratifying aspects of the past half year has been the remarkable price stability. The level of consumer prices in May -- the most recent month for which the data are available -- was only 1 percent above the level of six months earlier. Over the past 12 months, the rate of inflation of consumer prices has been only 3.5 percent. The level of producer prices was actually lower in June than it was last November when the recession ended. That implies that there will be continuing good news in consumer prices as these goods move from producers to retailers.

The sharp improvement in labor productivity this year and the moderate overall rise in labor compensation at current prices imply that unit labor costs are increasing at a low rate that also portends good inflation news. In the first quarter of 1983, unit labor costs in the nonfarm business sector rose at an annual rate of only 1.2 percent, down dramatically from the 7.2 percent increase in 1982 and the 11.2 percent increase in 1980.

Although an abnormal rise in farm prices or an increase in import costs could cause a temporary jump in the inflation rate, we anticipate that the broadest measure of inflation -- the GNP deflator -- will rise only about 4.5 percent this year, or half of its rate of increase in 1981. With a continuation of sound policy, inflation should remain essentially stable or decline in the years ahead.

The very good news about inflation in recent months is no excuse for complacency. Inflation will stay under control only if we keep it a high priority of government policy. The inflation rate has often been relatively low during the first year of an economic recovery but has then risen substantially in the years ahead. Thus, the inflation rate rose from 0.7 percent in 1961 to 6.1 percent in 1969, the final year of that recovery. Inflation then started at 3.4 percent in the first year of the 1971 recovery and rose to 8.8 percent two years later. And during the expansion that began in 1975, the inflation rate rose from 7 percent to more than 13 percent.

Experience shows that the rate of inflation rises when the level of demand is too high or when it is rising too fast. And once inflation starts to rise, expectations begin to change and the anticipation of further increases in inflation makes it that much more difficult to reduce the rate of inflation. Now, after a respite of just two years from the period of double digit inflation, the expectation of continuing relative price stability is still very fragile. So despite the remarkable success in reducing inflation since 1980, it is particularly important to remain vigilant and to prevent any rekindling of the inflationary spiral.

A wise friend of mine once commented that inflation is not a disease like appendicitis that can be cured with a single operation. Instead, inflation is like being overweight. We have to work at the problem all the time if we want to keep either inflation or our weight under control.

Although I think the analogy is very fitting, there is one important way in which inflation is more difficult to control than our weight. When we eat too much, the extra weight shows up immediately on our scales. In contrast, there are often substantial lags between the pursuit of inappropriate policies and the subsequent increase in inflation. That's why it's so important to consider the future consequences of current monetary and fiscal policy.

The President is strongly committed to avoiding a new round of inflation in the current recovery. I believe that Paul Volcker shares this concern and is determined to pursue a monetary policy that he believes has the greatest likelihood of achieving a sustained expansion with stable or declining inflation.

## Interest Rates

The principal problem facing our economy now is the high and rising level of real interest rates. These high interest rates are hurting key sectors of the economy, have raised the international value of the dollar to an uncompetitively high level, and are generating calls for monetary policies that, if pursued, would cause rising rates of inflation. Let me comment briefly on each of these points.

As you know, interest rates have been rising sharply for the past 10 weeks. The interest rate on Treasury bills is now over 9 percent, a full percentage point higher than at the beginning of May. Long-term Treasury bonds have also risen more than a percentage point since then and are now 11.3 percent. Other market interest rates have moved up in parallel. Short rates have not been as high as they are now since last summer and long rates have not been as high since last fall.

The increase in short-term market interest rates is likely to cause banks to raise their prime lending rate at almost any time. The prime is now 10.5 percent but is usually about 2.5 percentage points above the Treasury bill rate. Since the Treasury bill rate is now 9 percent, the prime by that standard would be about 11.5 percent. Moreover, the basic cost of incremental funds to the banks as measured by the rate on large CD's has increased about 1.5 percentage points since the banks lowered their prime rate from 11 percent to 10.5 percent.

Real interest rates are abnormally high for this stage of an economic recovery. During the first year of the past six recoveries the real interest rate on Treasury bills -- i.e., the excess of the Treasury bill rate over the rate of inflation -- was never as high as 2 percent. At present, the real interest rate on Treasury bills is at least 5 percent. Since investors' long-term price expectations cannot be observed, the long-term real rate cannot be measured with precision. Nevertheless, the market rate of more than 11 percent for long-term governments suggests an unusually high real long-term interest rate. In this regard, it is important to note that any future decline in long-term market interest rates caused solely by reductions in the public's expected inflation rate would leave real interest rates high.

Since it is the real interest rates on short-term and long-term securities that keep the exchange value of the dollar high and cause problems for interest sensitive industries, the current high real rates are a cause for serious concern.

The high and rising real interest rate on long-term bonds has caused the dollar to rise about 40 percent since 1980 relative to the other major currencies after adjusting to differences in inflation. Just since January of this year, the dollar has risen an average of nearly 8 percent relative to other major currencies. The strong dollar has caused a decline in exports and a rise in imports that is likely to result in a record merchandise trade deficit this year of more than $60 billion. By next year there is a substantial risk that the trade deficit will be more than $100 billion. Many key American industries are hit particularly hard by this fall in the competitiveness of U.S. exports and the increased attractiveness of imports.

The high real interest rates are also reducing the pace of activity in a number of interest sensitive sectors. For example, while capacity utilization rates in industries like food and textiles that are not interest sensitive are essentially back to their 1980 levels, the capacity utilization rates in an interest sensitive industry like iron and steel or the non-electrical machinery industry are still very much below 1980 levels. And while the real value of residential construction has increased sharply since the beginning of the recovery, nonresidential construction was way lower in May (the most recent month for which data are available) than it was when the recovery began. As a result, the real value of total new construction was the same in May as it was in November 1982.

It will of course be in 1984, the second year of the recovery, that the behavior of the interest sensitive sectors of the economy will be particularly important. The first year of the recovery is caused by the turnaround in inventory accumulation and the rise of consumer spending. Experience shows that the GNP growth rate in the second year of recovery typically slows substantially from the first year's growth. By the second year of the recovery, the inventory turnaround is essentially complete and an expansion of the usually interest sensitive sectors has to play a larger role.

The fundamental reason for the high level of real interest rates is the widespread expectation of large budget deficits for the remainder of the decade. Despite the recent increase in the projected rate of economic growth, budget deficits are likely to remain in the $150 billion to $200 billion range unless legislative action is taken. It is sad but true that increases in the rate of growth reduce deficits by amounts that are very small relative to the projected deficits; a full 1 percent increase in the GNP reduces the deficit by less than $15 billion. Budget deficits of $150 billion to $200 billion would absorb funds equal to between half and two-thirds of the net private saving of households, businesses, and State and local governments. To reduce the borrowing demand of private investors and households to the remaining small amount of funds would inevitably require high real interest rates.

Despite the fundamental importance of the projected budget deficits as determinants of the existing level of real interest rates, much of the day-to-day public discussion of interest rates focuses on the Federal Reserve. Perhaps that is only natural. The Federal Reserve does affect interest rates and the seemingly mysterious nature of open market operations is a natural subject for speculation. Since the financial markets are aware of the Federal Reserve's monetary targets, any unintended increases in one of the monetary aggregates induces expectations of further Federal Reserve tightening and therefore immediately raises interest rates.

It is important, however, to recognize that the fundamental equilibrium real interest rate reflects the basic supply and demand for funds in the economy. If the government increases its demand for funds, the real interest rate will rise. If individuals want to save more at every interest rate, the real interest rate will fall. Economists traditionally called the interest rate that balanced the supply and demand for funds the "natural" interest rate. Although the Federal Reserve's monetary policy can cause the market's real interest rate to depart temporarily from this "natural" rate of interest, the fundamental determinant is not monetary policy but the supply and demand for funds. As long as the Federal Reserve follows a prudent monetary policy that avoids raising the future inflation rate, large outyear deficits will inevitably mean high real interest rates.

Although the Federal Reserve could temporarily lower short-term interest rates by explicitly adopting a policy of rapid expansion of the money stock, this would subsequently lead to higher rates of inflation and higher market rates of interest.

Experience shows that faster money growth leads to higher inflation and higher interest rates. Although the relationship among money, inflation and interest rates is complex, the essence of the relationship can be illustrated by comparing five-year averages from the first half of the 1960s through the last half of the 1970s. Table 1 shows that the average rate of growth of M1 (using the 1983 definition of that variable) rose in each successive five year period. The average rate of CPI inflation also rose and carried with it the average yield on Treasury bills. Any notion that a sustained increase in money growth rates can cause a sustained decline in interest rates is contrary to both experience and economic theory.

## MONEY GROWTH, INFLATION, AND INTEREST RATES

| Period | Average M1 Growth | Average CPI Inflation | Average 3-Month Treasury Bill Rate |
|---|---|---|---|
| 1960-64 | 2.8 | 1.2 | 2.9 |
| 1965-69 | 5.0 | 3.8 | 5.0 |
| 1970-74 | 6.2 | 6.7 | 5.9 |
| 1975-79 | 7.1 | 8.2 | 6.7 |

Although no one can like the high real interest rates that we see today, it would be a mistake for the Federal Reserve to pursue an expansionary monetary policy aimed at reducing those rates. The effect of such a policy would be an ineluctable resurgence of inflation and a new rise of market rates of interest. Only by reducing the growth of M1 can the interest rate be reduced.

## Monetary Aggregates

The appropriate aim of monetary policy should instead be to provide enough money and credit to permit a continuation of real growth with stable or declining inflation. For 1984, for example, the Administration forecast projects a 4.5 percent growth of real GNP and a 5.0 percent rise in the prices (as measured by the GNP deflator). These two figures imply that nominal GNP, i.e., GNP in current prices, will rise at 9.7 percent.1/ A faster rate of growth of nominal GNP would be expected to result in both a higher rate of real GNP growth and a higher rate of inflation.

What rate of growth of M2 is consistent with a rise of nominal GNP at a rate of about 9.7 percent? Historic experience indicates that on average nominal GNP rises at

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1/ The nominal GNP growth rate is slightly greater than the sum of the two component growth rates because (1.045) (1.050) = 1.097.

about the same rate as the rate of increase of M2 some months earlier. Of course, sometimes GNP grows faster and sometimes it grows more slowly. But a useful starting point is therefore to assume that the economy will require a rate of growth of M2 of about 9.7 percent for the next 12 months to produce the projected rate of nominal GNP growth.

This required M2 growth rate is consistent with the Federal Reserve's target range of M2 growth of between 7 percent and 10 percent, and with the actual M2 growth rate of about 9 percent during the past three months. Although the M2 growth rates earlier this year were much higher than 10 percent, I am reluctant to put any weight on that experience because of the major changes caused by the introduction of MMDA's and Super NOW accounts.

The historic experience indicates a different relationship between nominal GNP and M1 with nominal GNP rising about 3 percent faster each year than the stock of M1. That is, individuals and businesses have on average reduced their use of M1 per dollar of GNP at a 3 percent annual rate. This suggests then that a M1 growth rate of about 7 percent would be compatible with the nominal GNP growth forecast by the Administration. Although an M1 growth rate of 7 percent is in the middle of the newly announced Federal Reserve target range for M1, it is very much below the actual growth rate of M1 during the past several months.

In the three months from March through June, M1 grew at a rate of 12 percent. If the historic trend in velocity prevails, a persistence of M1 growth at 12 percent would lead to nominal GNP growth of 15 percent, or about 5 percentage points higher than the Administration's forecast. This would undoubtedly mean an inflation rate substantially greater than the 5 percent that we have forecast, probably an inflation rate as high as 7 to 10 percent by 1984-85. It is for this reason that the growth rate of M1 must be slowed.

You may have heard comments from some individuals who say that a fast rate of M1 growth can be ignored since the recent M2 growth is compatible with the Administration's forecast growth of nominal GNP. I do not agree with them. Most economists who have studied the relationships between the monetary aggregates and GNP believe that M1 has been a somewhat better guide than M2 to the future path of income and inflation. Whether or not one accepts that judgment, some weight must be given to the behavior of M1 in assessing the appropriateness of monetary policy. Moreover, the appropriate goal of policy at this time should be to slow M1 without reducing the growth rate of M2.

It is, of course, always possible that institutional changes or other factors are causing a decline in the M1 velocity (the ratio of nominal GNP to M1), implying that the current M1 growth is not excessive. Last fall and winter I repeatedly defended the Federal Reserve's policy of allowing M1 to grow rapidly in the second half of 1982, and explained at that time that the apparently rapid growth was in fact just a one time "level adjustment" in the stock of money that would permit interest rates to adjust to the lower level of inflation that had already been achieved. Similarly, in the first quarter of this year, the introduction of the Super NOW accounts and Money Market Deposit Accounts made the interpretation of changes in M1 so uncertain that criticism of the 17 percent M1 growth rate would have been inappropriate. Although it is possible that the M1 growth figures are still being distorted by the regulatory changes earlier this year, a detailed examination of the individual components of M1 provides no real support for that view. Moreover, without the sharp decline in interest rates of the type that occurred last summer, there will be no interest-induced decline in velocity; if anything, the current rising interest rates will increase velocity and add to the risk of inflation.

The money targets must, of course, never become ends in themselves. They must be understood as a way of achieving an appropriate long-run path for the economy. If sustained experience shows that the money targets are not compatible with a desired level of GNP growth, the money targets must eventually be recalibrated. But in the absence of clear evidence of a velocity change or reasons to believe that a shift of money demand has occurred, a money growth target based on the past velocity experience is an appropriate basis for guiding the monetary aggregates. And while it would be wrong to worry very much about one or two months of abnormal money growth, a persistent rate of growth that is roughly twice a suitable target value is unacceptable and should be decreased. I think that the Federal Reserve policy, announced yesterday by Paul Volcker, of bringing the M1 growth rate down to a 5 percent to 9 percent range for the remainder of the year is appropriate. It is now very important to bring the actual M1 growth rate down into this range.

Short term interest rates have risen in anticipation of such a policy aimed at slowing the growth of M1. Further increases in interest rates may continue in the months ahead. It is, of course, impossible to know how much further, if at all, interest rates must rise in order to bring M1 growth back to an acceptable rate. The financial future markets and the interest rates on one-year and two-year bonds indicate clearly that financial investors expect short-term rates to continue rising. While no one likes to see interest rates rise, an increase in interest rates over the next few months would be far better than a continuing surge of money growth that led by 1984 or 1985 to a revival of rapid inflation followed by another economic downturn.

The anticipation that the Federal Reserve will pursue an appropriate policy to slow M1 growth explains why, despite the rapid growth of M1, the financial markets do not appear to be concerned about a near-term rise in inflation. The price of inflation hedges like gold has not risen as it would if a new inflationary surge were feared. Similarly, the rise in the exchange value of the dollar shows confidence that the purchasing power of the dollar will not be eroded and a belief that the rise in interest rates represents a rise in real rates and not a compensation for faster anticipated inflation.

## Budget Deficits

Although the focus of these hearings is on monetary policy, I cannot conclude without returning to the problem of budget deficits. Budget deficits of the magnitude that may prevail in the years ahead would do very substantial harm to the American economy. The lower rate of capital formation would hurt production, decrease growth, limit the rise in real incomes and weaken our international competitiveness.

In the near term, large anticipated budget deficits and the high real interest rates that they cause make the recovery unbalanced and therefore inherently more fragile. The prospect of large budget deficits very much complicates the task of monetary policy.

The budget that the President submitted to Congress earlier this year recognizes the importance of reducing the deficit and proposes legislative action to shrink the deficit to about 2 percent of GNP by 1987-88 as a result of domestic spending cuts and revenue increases.

The share of GNP devoted to domestic spending by the Federal Government has doubled since 1960, rising from 8 percent to 16 percent. Shrinking that share is essential if we are to avoid perpetual deficits or unacceptable tax increases.

Spending cuts must also be accompanied by additional tax revenue. Ideally, the extra revenue will be forthcoming without a rise in tax rates because economic growth substantially exceeds our forecast. But if this does not occur, the President's budget calls for an increase in tax rates that begins in October 1985: a 5 percent surcharge on personal and corporate tax payments and a $5-a-barrel tax on imported and domestic oil. The Administration remains firmly committed to these standby tax increases and to the budget of which they are so vital a part.

Two aspects of the Administration's tax proposal should be noted. First, there should be no increase in tax rates in either this year or next while the recovery is getting established. Second, the subsequent conditional tax increase should be enacted this year in order to reassure financial markets and other investors that the deficits will be shrinking. The resulting change in projected deficits would permit an immediate decline in long-term interest rates and a favorable adjustment of the exchange value of the dollar.

The combination of spending restraint and the enactment this fall of such tax legislation would provide the much needed evidence that budget deficits will indeed begin declining sharply after the recovery is firmly established. And that evidence would be the key to a sound and healthy recovery in the months and years ahead.

Senator **Gorton**. I have to apologize to our next three witnesses. We now have a rollcall. And I will try to be back within 15 minutes. We will then start with Secretary Sprinkel immediately.

[Recess.]

Senator **Gorton**. Mr. Secretary, our apologies for using up so much of your day. I am grateful for your patience.

As you know, your entire statement will be included in the record as if read in full. If you would like to summarize it, you may.

## STATEMENT OF BERYL W. SPRINKEL, UNDER SECRETARY FOR MONETARY AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. **Sprinkel**. Thank you, Senator Gorton. It is a pleasure to appear before your committee to discuss monetary policy. I will present an abbreviated version of my testimony.

While it often seems impossible for economists and politicians to agree either among themselves, or with each other, about much of anything, it is clear that we all agree on the desirability of low interest rates. It is often vaguely asserted that there is some group of people out there somewhere that favors high interest rates; I cannot imagine who those people would be. This administration has sometimes been accused of pursuing a policy of high interest rates; nothing could be further from the truth. We have consistently emphasized the need to reduce inflation and interest rates as a prerequisite to sustainable real economic growth and can, I believe, point with pride to the reduction in inflation and interest rates that have occurred in the past 2½ years.

In the current situation, domestic as well as international concerns provide compelling economic arguments for lower interest rates. Domestically, the level of interest rates will be an important determinant of the mix of output growth as the economy expands; lower interest rates would encourage capital investment that is needed to expand job opportunities, improve productivity, and enhance the ability of U.S. industry to compete abroad. On the international front, the implications of a sustained increase in U.S. interest rates are serious. Since much of the debt negotiated by less developed countries carries variable interest rates, their repayment burdens are highly sensitive to increases in U.S. interest rates.

### HOW TO GET LOWER INTEREST RATES

The desirability of lower interest rates is clear; that is not the issue. The issue is how do we achieve them. The only way that interest rates can be expected to resume the decline that began about 1 year ago is if we—the administration, the Congress and the Federal Reserve—take the monetary and fiscal actions needed for a low-interest-rate environment. Economic and political rhetoric will not do the job, we cannot stand on the shore and order the tide not to come in.

It is important to remember that interest rates—though still higher than any of us would like—are now considerably lower than they were 1 year ago and 2½ years ago. The table in my text shows the current level of some representative short- and long-term market interest rates and the substantial declines that have occurred since a year ago and since December 1980. There has been an impressive improvement in other rates as well; the prime rate, for example, is now 600 basis points below where it was a year ago, and 1,100 basis points below its December 1980 level. Obviously, we would all like to see continued progress. In that regard, it is particularly troublesome that market rates have ceased their decline and have begun to rise again since early May. That also is in the table.

It is equally important, I think, to understand the timing of the movement in rates over the past year. As is illustrated in chart 1, nearly all of the decline in short-term rates achieved in the past year occurred during July and August 1982; this is shown by the dotted line in the chart. Since last fall, short-term market rates have followed their usual uneven path, but they have achieved no further net decline; the 30-day commercial paper rate is now 98 basis points above the low point it reached in the last week of August 1982. Long-term rates fell for a longer period of time last summer and fall, but also leveled off by early November, and have recorded no further net declines; the rate on long-term Government bonds is now 109 basis points above its November low.

The solid line on the chart depicts the 13-week rate of money growth which began accelerating dramatically in September and has remained in the double-digit range ever since. Thus, the facts clearly contradict the widespread and much-publicized views that interest rates fell last year "after the Fed eased up on money growth." By the time the acceleration of money growth became evident last fall, the decline in short rates had already occurred. Furthermore, the rapid money growth of the last 9 or 10 months has not provided for any further decline in rates.

There is some validity to the commonsense notion that more money growth induces lower interest rates. The actions taken by the Federal Reserve to expand money growth increase the reserves available to the banking system; initially, this increased liquidity can, and in some cases does, cause short-term interest rates to fall. If reserve and money growth continue at a rapid rate, however, eventually this liquidity effect is offset by, and ultimately is dominated by, the market's long-term concerns about excessive money growth. These concerns may take the form of inflationary expectations which tend to put upward pressure on long-term rates, or uncertainty about the prospects of tightening actions by the Federal Reserve, which, in turn, puts upward pressure on short-term rates; or some combination of the two.

How quickly and how strongly the upward rate pressures emanating from an acceleration of money growth outweighs the initial liquidity effects depends on several complex issues, such as the initial state of inflationary expectations, the previous path of money growth relative to its target range, the credibility of Federal Reserve and administration policy actions and statements, and current and prospective economic and financial market conditions. The public's expectations and reactions to Federal Reserve actions are frequently very important to the behavior of interest rates; they and many other forces, limit the Federal Reserve's ability to determine, or even influence, interest rates with the precision that the public typically presumes is possible. In particular, the Federal

Reserve has no ability over any prolonged period of time to generate lower interest rates by increasing the rate of monetary expansion; under some circumstances, its ability to do so even for the immediate short run can be severely limited.

The accumulating evidence of a stronger-than-expected recovery is a predictable result of a highly stimulative monetary policy. Historically, a sustained acceleration of money growth causes an expansion in economic activity 6 to 9 months later. And that is no different this time. Economic stimulus is, however, only the immediate, temporary effect of accelerated money growth; if excessive money growth is maintained, the permanent effects are rising inflation and rising interest rates which are pervasive deterrents to real economic growth.

In this context, the recent rise in interest rates—while not yet large enough to pose a real threat to the economy—is an ominous sign. The financial markets are well aware of the inflationary potential of more months of rapid money growth. This concern is compounded by the budget situation; large projected deficits generate concern that the Federal Reserve may monetize them. This possibility reinforces the widespread skepticism that the Government will adhere to noninflationary policies over the long run.

### THE RELATIONSHIP OF MONEY GROWTH TO VELOCITY

A common justification of the record-high money growth over the past 10 months is the decline in velocity that has occurred in the last year. Arithmetically, velocity is simply the ratio of nominal GNP to the money supply. In terms of the public's behavior, velocity represents the fundamental behavioral relation between the amount of spending the public does and the quantity of money in its hands.

Historically, velocity in the United States has been reasonably predictable, despite changing economic conditions and substantial institutional changes. This reliable relation is the basis of a policy of controlling the rate of money growth in order to influence the rate of growth in nominal GNP. It is the premise for the recommendation that moderate, noninflationary money growth will, over the long run, facilitate real economic growth without inflation and for the recommendation that stable money growth would minimize the fluctuations in nominal GNP growth.

The decline in velocity that has occurred leads some to believe that the basic relation between money and nominal GNP growth has been altered, and that therefore money growth should be permanently increased to compensate for a permanently lower rate of velocity growth. The decline in velocity leads others to suspect the validity of the basic policy approach of controlling the rate of money growth. Since the issue is very important to the conduct of monetary policy, and is also widely misunderstood, I believe it is important to explore the historical and recent behavior of velocity in more detail.

First, it is important to recognize that velocity typically declines during a recession. Furthermore, the decline in inflation and inflationary expectations in the last year and a half would also be expected to cause velocity growth to fall. Therefore, a part of the decline in velocity can be attributed to its normal cyclical behavior, reinforced by the substantial decline in inflation. But as many have observed, the decline in velocity in the recession that ended in 1982 was larger than that for previous ones.

An often-overlooked fact is that a substantial proportion of the recent decline in velocity can be directly attributed to the acceleration of money growth itself. An acceleration of money growth in one quarter cannot be expected to induce higher nominal GNP growth in that same quarter; it takes two to three quarters for an increase in money growth to stimulate spending and induce an associated increase in nominal GNP growth. Since a large increase in the rate of money growth causes no immediate increase in nominal GNP—it is the numerator in that ratio—and velocity growth is simply the ratio of nominal GNP growth to money growth, the immediate effect of accelerated money growth is likely to be a contemporaneous decline in velocity. Ultimately, the accelerated money growth stimulates nominal GNP growth and velocity rebounds. And that is what is currently happening. But if money growth continues at a rapid pace, as it has over the last 10 months, velocity could continue—and it was for a while—to be suppressed until nominal GNP growth catches up to the increased money growth. It was announced this morning that the rate of nominal GNP growth last quarter was 13.2 percent, reflecting not what happened to the money supply in the second quarter but what happened to the money supply in the quarters prior to that. The initial catch-up of nominal GNP growth may consist of an above-average increase in real GNP, but if accelerated money growth persists, real growth will abate as inflation takes over.

As chart 2 illustrates, the large swings in velocity since 1980 coincide with similarly large swings in money growth in the opposite direction. This is particularly the case for the widely-cited decline in velocity observed in the last quarter of 1982.

An immediate decline in velocity would therefore be expected with an acceleration of money growth of the magnitude that has occurred in the last three quarters. This is particularly true since it followed a prolonged period of relatively slow growth, the lagged, depressing effect of which was still being felt on nominal GNP after money growth was reaccelerated. If money growth is slowed over the next few quarters, velocity would be expected to rise. This may well have started in the second quarter. This would occur, not only as a result of the slowdown in money growth, but also because the lagged effect of the past few quarters of rapid money growth will continue to stimulate nominal GNP.

This sounds a little complicated, but it really is not. Pumping in a rapid increase of money today does not immediately affect nominal GNP. However, it does affect imputed velocity and causes it to go down sharply.

## CONTROLLING THE MONEY SUPPLY

Those who emphasize the importance of controlling the money stock have never based their recommendation on the presumption that velocity was stable from one quarter to the next or even from one year to the next. It is the long-run predictability of the velocity relationship that makes monetary targeting a reliable basis for stabilization policy. At the same time, the short-run, unpredictable fluctuations in velocity indicate that attempts to tailor money growth to perceived or expected changes in velocity are not likely to be successful. The lag in the effect of money growth on economic activity, and the variability of that lag, not only imply that fluctuations in velocity will occur, but also that attempting to fine-tune money growth to those fluctuations is a very risky, and potentially damaging, approach to monetary policy.

Those who believe that a permanent decline in velocity has occurred, and that it necessitates a permanently higher rate of money growth, typically attribute the change in velocity to the effects of financial innovation and deregulation. Since the payment of market interest rates on transaction accounts—which are included in the $M_1$ measure of the money supply—represents a fundamental change in our financial system, it is possible that it has altered the public's behavior with respect to their money holdings. It may be that the observed decline in velocity partially reflects a fundamental and lasting change in the public's behavior. If so, the issue becomes an empirical one of determining the change in either the level or trend rate of velocity and adjusting the money growth targets accordingly. Even after adjusting recent money growth for the growth of deposits now included in $M_1$ that may have attributes of savings, money growth remains high by any historical standard.

Basing policy on the presumption that a permanent change in velocity has occurred is very risky. This is not the first time these arguments have been made. It has happened many times, and on each occasion velocity came back to its normal pattern, as I expect it to do this time. In the current situation, it is a risk that is biased in the direction of more inflation, higher interest rates, and lower real economic growth in the years ahead. The risk of allowing money growth to continue at its current pace is not just the inflationary threat it poses for the future; in addition, postponing action to slow money growth carries the risk that once corrective actions are taken, they will be damaging and destabilizing to the economy—meaning by that, the recovery is squelched.

Short-term fluctuations in the velocity relationship have led some to assert that control of money growth is no longer a viable approach to monetary policy. Others have become impatient with controlling money growth because it seems abstract and removed from the very real economic problems we face, such as inflation, high interest rates, or unemployment.

I think that we sometimes lose sight of why it is that we are so concerned, at least some of us, about controlling the money supply. We do not seek to control money just to give the Federal Reserve something to do, or because it is an interesting exercise. Money growth is important because of its predictable long-run relation to the growth of nominal GNP, and its close correlation with the rate of inflation over the long run.

Effective monetary policy actions require only that there exist some economic variable—be it the money supply, monetary base, or the price of widgets—that meet two conditions: First, it must be controllable—and ideally with some precision—by the Federal Reserve. This condition eliminates a lot of potential candidates, including the price of widgets.

Second, it needs to be an economic variable that is related in a reliable way to the economic variables we ultimately wish to affect: prices, output, and employment growth.

While the money is not a perfect variable on which to base monetary policy, it is far more reliable and technically workable than most of the alternatives. With the exception of some measures of bank reserves and the monetary base, most of the alternative variables proposed as targets for monetary policy fail the first condition listed above; namely, controllability.

In addition to the monetary discipline they can impose, money growth targets can be an important shorthand description of the central bank's intention with respect to future inflation. Once a tradition of setting and achieving credible monetary targets is established, the targets can also give very important information to the financial markets and investors. That information can contribute much to promoting financial market stability and reducing the uncertainty that surrounds investment decisions.

It is a futile and ultimately self-defeating policy to use excessive monetary expansion in an attempt to drive interest rates down. In the long run, the results of that policy are just the opposite: high, or rising, interest rates. Economic developments over the past two decades demonstrate the point that inflationary monetary policy yields not only more inflation, but less real growth, and higher unemployment and higher interest rates as well.

The table included provides long-term 5-year averages for money growth, inflation, interest rates and real economic growth since 1960, plus the averages for 1981–82. As is shown in the table, the average rate of money growth has accelerated steadily since 1960. This rising trend of money growth has been associated with a similar acceleration in the average rate of inflation, as shown by the GNP deflator, and long-term interest rates, as represented by the Corporate AAA bond rate.

Note, however, that persistent monetary stimulus did not result in lasting economic growth. In the two decades from 1961 to 1980, the 5-year average of money growth more than doubled, but average growth in real GNP declined. Furthermore, the average unemployment rate was more than a full percentage point higher in the 1976–80 period than in the 1961–65 period. Thus, more than doubling the rate of money growth over the two decades did not "buy" us more real growth or less unemployment; it "bought" us higher inflation, and interest rates, and lower growth and higher unemployment. The inflation and high interest rates caused by prolonged excessive monetary expansion are detrimental to real economic growth and over the long run outweigh any short-run stimulus that may be induced by accelerating money growth.

## FED NEEDS GRADUAL SLOWDOWN OF MONEY GROWTH

Well, where do we go from here? The task that now confronts the Federal Reserve is to achieve a gradual slowing in the rate of money growth and avoid any severe or prolonged period of excessive monetary restraint. Continuing to allow money to grow at an excessive pace will not produce the lower interest rates that all of us desire. With enormous uncertainty in the financial markets about monetary policy and the rise in long-term rates in the last months, the financial markets are likely to react adversely to a continuation of rapid money growth.

Those who oppose a slowing in the rate of money growth do so because they fear the rise in short-term rates that may accompany such a policy. It is likely, however, that any rise in rates associated with the slowing of reserve and money growth would be relatively short lived. Furthermore, the short- and long-term rates are already rising in response to the protracted period of excessive, above-target money growth. While the temporary rise in interest rates that may accompany a slowing of money growth is nothing to applaud, it is preferable to the permanent rise in long-term rates that can be expected if money growth continues unabated.

In the recent past, the effects of institutional change have generated considerable uncertainty and controversy about the behavior of the monetary aggregates. Those uncertainties have made it difficult to interpret the path of money growth in recent months. Some form of uncertainty is inherent in the process of conducting monetary policy, and risks are always associated with the alternative policy actions available to the Federal Reserve. The challenge for policymakers is to pursue policies that minimize the implied risk to economic performance and stability. My concern is that the path of money growth that has occurred in the last 10 months does not represent a policy that minimizes risk. To the contrary, it is a highly risky policy, with the risk heavily skewed toward higher inflation and interest rates in the years ahead.

It is best that the Federal Reserve not attempt to reverse the recent surge in money growth, as any severe or abrupt restriction of money growth would almost certainly be damaging to the economy. What is needed, and I hope that is what we will get, is for the Federal Reserve to take the policy actions immediately required to provide a gradual slowdown of money growth.

It is vitally important that we remain sensitive to the danger of repeating the mistakes of the past when rapid money growth has been allowed to continue into the recovery phase, laying the groundwork for a renewed resurgence of inflation. Recognizing the lag in the effect of money growth on inflation, it is clear that if actions to slow the rate of money growth are delayed until an actual increase in inflation is observed, it will be too late to take the necessary preventive actions.

Thank you, Senator Gorton.

[The complete statement follows:]

# STATEMENT OF BERYL W. SPRINKEL
UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
WASHINGTON, D.C.

Thursday, July 21, 1983

Chairman Garn, Senator Proxmire, other distinguished members of the Committee, it is a pleasure to be here today to discuss monetary policy with you.

While it often seems impossible for economists and politicians to agree, either among themselves, or with each other, about much of anything, it is clear that we can all agree on the desirability of low interest rates. It is often vaguely asserted that there is some group of people out there somewhere that favors high interest rates; I cannot imagine who those people would be. This Administration has sometimes been accused of pursuing a policy of high interest rates; nothing could be further from the truth. We have consistently emphasized the need to reduce inflation and interest rates as a prerequisite to sustainable real economic growth and can, I believe, point with pride to the reduction in inflation and interest rates that have occurred in the past two and one-half years.

In the current situation, domestic as well as international concerns provide compelling economic arguments for lower interest rates. Domestically, the level of interest rates will be an important determinant of the mix of output growth as the economy expands; lower interest rates would encourage the capital investment that is needed to expand job opportunities, improve productivity, and enhance the ability of U.S. industry to compete abroad. On the international front the implications of a sustained increase in U.S. interest rates are serious. Since much of the debt negotiated by less developed countries carries variable interest rates, their repayment burdens are highly sensitive to increases in U.S. rates.

The desirability of lower interest rates is clear; that is not the issue. The issue is how to achieve them. The only way that interest rates can be expected to resume the decline that began about one year ago is if we -the Administration, the Congress and the Federal Reserve -- take the monetary and fiscal policy actions needed for a low interest rate environment. Economic and political rhetoric will not do the job; we cannot stand at the shore and order the tide not to come in.

It is important to remember that interest rates -- though still higher than any of us would like -- are now considerably lower than they were a year ago, and two-and-a-half years ago. The table below shows the current level of some representative short- and long-term market interest rates and the substantial declines that have occurred since a year ago and since December 1980. There has been an impressive improvement in other rates as well; the prime rate, for example, is now 600 basis points below where it was a year ago and 1100 basis points below its December 1980 level. Obviously, we would all like to see continued progress. In that regard, it is particularly troublesome that market rates have ceased their decline and have begun to rise again since early May; this is shown in the last column of the table.

Changes in Short- and Long-Term Market Interest Rates

| | Most Recent Weekly Average (7/15/83) | Change (Basis Points) Compared to: | | |
|---|---|---|---|---|
| | | One Year Ago (Week of 7/2/82) | 2 1/2 Years Ago (Week of 12/26/80) | 2 Months Ago (Week of 5/6/83) |
| 3-month CD rate | 9.51% | -570 | -809 | +119 |
| 3-month Treasury bill rate | 9.07 | -374 | -555 | +104 |
| Corporate AAA rate | 12.13 | -294 | -76 | +84 |
| Long-term government bond rate | 11.12 | -230 | -26 | +112 |

It is equally important to understand the timing of the movement in rates over the past year. As is illustrated in Chart 1 on the next page, nearly all of the decline in short-term rates achieved in the past year occurred during July and August of of 1982; this is shown by the dotted line in the chart. Since last fall, short-term market rates have followed their usual uneven path, but they have achieved no further net decline; the 30-day commercial paper rate is now 98 basis points above the low point it reached in the last week of August, 1982. Long-term rates fell for a longer period of time last summer and fall, but also leveled off by early November, and have recorded no further net declines; the rate on long-term government bonds is 109 basis points above its November low.

The solid line on the chart depicts the 13-week rate of money growth which began accelerating dramatically in September and has remained in the double-digit range ever since. Thus, the facts clearly contradict the widespread and much-publicized view that interest rates fell last year "after the Fed eased up on money growth." By the time the acceleration of money growth became evident last fall, the decline in short rates had already occurred. Furthermore, the rapid money growth of the last 9-10 months has not provided for any further declines in rates.

There is some validity to the common-sense notion that more money growth induces lower interest rates. The actions taken by the Federal Reserve to expand money growth increase the reserves available to the banking system; initially, this increased liquidity can cause short-term interest rates to fall. If reserve and money growth continue at a rapid pace, however, eventually this liquidity effect is offset by, and ultimately is dominated by, the markets' long-term concerns about excessive money growth. These concerns may take the form of inflationary expectations (which puts upward pressure on long-term rates), or uncertainty about the prospects of tightening actions by the Fed (which puts upward pressure on short-term rates), or a combination of both.

How quickly and how strongly the upward rate pressures emanating from an acceleration of money growth outweigh the initial liquidity effects depends on the complex interaction of a variety of factors including the initial state of inflationary expectations, the previous path of money growth relative to its target range, the credibility of Federal Reserve and Administration policy actions and statements, and current and prospective economic and financial market conditions. The public's expectations and reactions to Federal Reserve actions are frequently very important to the behavior of interest rates; they, and many other forces, limit the Federal Reserve's ability to determine, or even influence, interest rates with the precision that the public typically presumes is possible. In particular, the Federal Reserve has no ability over any prolonged period of time to generate lower interest rates by increasing the rate of monetary expansion; under some circumstances, its ability to do so even for the immediate, short run can be severely limited.

The accumulating evidence of a stronger-than-expected recovery is a predictable result of a highly stimulative monetary policy; historically a sustained acceleration of money growth causes an expansion in economic activity six to nine months later. Economic stimulus is, however, only the immediate, temporary effect of accelerated money growth; if excessive money growth is maintained, the permanent effects are rising inflation and interest rates which are pervasive deterrents to real economic growth.

In this context, the recent rise in interest rates -- while not yet large enough to pose a real threat to the recovery -- is an ominous sign. The financial markets are well aware of the inflationary potential of more months of rapid money growth. This concern is compounded by the budget situation;

large projected budget deficits generate concern that the Fed may monetize them. This possibility reinforces the widespread skepticism that the government will adhere to noninflationary policies over the long run.

## The Behavior of Velocity

A common justification of the record-high money growth of the past ten months is the decline in velocity that has occurred in the last year. Arithmetically, velocity is simply the ratio of nominal GNP to the money supply. In terms of the public's behavior, velocity represents the fundamental behavioral relation between the amount of spending the public does and the quantity of money in its hands.

Historically, velocity in the U.S. has been reasonably predictable, despite changing economic conditions and substantial institutional changes. This reliable relation is the basis of a policy of controlling the rate of money growth in order to influence the rate of growth in nominal GNP. It is the premise for the recommendation that moderate, noninflationary money growth will, over the long run, facilitate real economic growth without inflation and for the recommendation that stable money growth would minimize the fluctuations in GNP growth.

The decline in velocity that has occurred leads some to believe that the basic relation between money and nominal GNP growth has been altered, and that therefore money growth should be permanently increased to compensate for a permanently lower rate of velocity growth. The decline in velocity leads others to suspect the validity of the basic policy approach of controlling the rate of money growth. Since the issue is very important to the conduct of monetary policy, and is also widely misunderstood, I believe it is important to explore the historical and recent behavior of velocity in more detail.

First, it is important to recognize that velocity growth typically declines during a recession. Furthermore, the decline in inflation and inflationary expectations in the last year and a half would also be expected to cause velocity growth to fall. Therefore, a part of the decline in velocity can be attributed to its normal cyclical behavior, reinforced by the substantial decline in inflation. But, as many have observed, the decline in velocity in the recession that ended in 1982 was larger than that for previous ones; the average decline in velocity for previous postwar recessions was 1.3%, compared to 3.7% from third quarter 1981 to the fourth quarter of 1982.

An often-overlooked fact is that a substantial proportion of the recent decline in velocity can be directly attributed to the acceleration of money growth itself. An acceleration of money growth in one quarter cannot be expected to induce higher nominal GNP growth in the same quarter; it takes two or three quarters for an increase in money growth to stimulate spending and induce an associated increase in nominal GNP growth. Since a large increase in the rate of money growth causes no immediate increase in nominal GNP, and velocity growth is simply the ratio of nominal GNP growth to money growth, the immediate effect of accelerated money growth is likely to be a contemporaneous decline in velocity. Ultimately, the accelerated money growth stimulates nominal GNP growth and velocity rebounds. But if money growth continues at a rapid pace, as it has over the last ten months, velocity could continue to be suppressed until nominal GNP growth "catches up" to the increased money growth. The initial "catch-up" of nominal GNP growth may consist of an above-average increase in real GNP, but if accelerated money growth persists, real growth will abate as inflation takes over.

As Chart 2 illustrates, the large swings in velocity since 1980 coincide with similarly large swings in money growth in the opposite direction. This is particularly the case for the widely-cited decline in velocity observed in the last quarter of 1982.

When money growth is accelerated, an immediate and initial decline in velocity is not surprising or unusual. For example, from the first to the second quarter of 1971, money growth was accelerated from a quarterly growth rate of 7.2% to 9.3%; velocity which had risen at an 8.4% annual rate in the first quarter fell at a 1.8% rate in the second quarter. Thus, an increase in money growth induced a substantial decline in velocity even though the economy was in the early stages of a recovery.

An immediate decline in velocity would therefore be expected with an acceleration of money growth of the magnitude that has occurred in the last three quarters. This is particularly true since it followed a prolonged period of relatively slow money growth, the lagged, depressing effect of which was still being felt on nominal GNP after money growth was reaccelerated. If money growth is slowed over the next few quarters, velocity would be expected to rise. This would occur, not only as a result of the slowdown in money growth, but also because the lagged effect of the past few quarters of rapid money growth will continue to stimulate nominal GNP.

Primarily because of the lag in the effect on nominal GNP growth of a change in the rate of money growth, velocity can be expected to display sizeable short-run fluctuations, particularly when money growth is volatile. Since 1980, the variation in velocity has increased; comparing the period since the beginning of 1980 with the preceding 18 years, quarterly variability of velocity has more than doubled. The increased fluctuations observed in velocity growth, however, have coincided with a proportionate increase in the volatility of money growth; comparing the same two periods, variability in money growth has also more than doubled.

Those who emphasize the importance of controlling the money stock have never based their recommendations on the presumption that velocity was stable from one quarter to the next or even one year to the next. It is the long-run predictability of the velocity relationship that makes monetary targeting a reliable basis for stabilization policy. At the same time, the short-run, unpredictable fluctuations in velocity indicate that attempts to tailor money growth to perceived or expected changes in velocity are not likely to be successful. The lag in the effect of money growth on economic activity, and the variability of that lag, not only imply that fluctuations in velocity will occur, but also that attempting to fine-tune money growth to those fluctuations is a very risky, and potentially damaging, approach to monetary policy.

Those who believe that a permanent decline in velocity has occurred, and that it necessitates a permanently higher rate of money growth, typically attribute the change in velocity to the effects of financial innovation and deregulation. Since the payment of market interest rates on transactions accounts (which are included in the M1 measure of the money supply) represents a fundamental change in our financial system, it is possible that it has altered the public's behavior with respect to their money holdings. If so, it is logical that people may now choose to hold larger money (M1) balances relative to spending and income; such a behavioral change would mean a decline in velocity. It may be that the observed decline in velocity partially reflects a fundamental and lasting change in the public's behavior. If so, the issue becomes an empirical one of determining the change in either the level or trend rate of velocity and adjusting the money growth targets accordingly. Even after adjusting recent money growth rates for the growth of deposits now included in M1 that may have attributes of savings, money growth remains high by any historical standard.

Basing policy on the presumption that a permanent change in velocity has occurred is very risky. In the current situation, it is a risk that is biased in the direction of more inflation, higher interest rates and lower real economic growth in the years ahead. The risk of allowing money growth to continue at its current pace is not just the inflationary threat it poses for the future; in addition, postponing action to slow money growth carries the risk that once corrective actions are taken, they will be damaging and destabilizing to the economy.

## The Importance of Controlling Money Growth

Short-term fluctuations in the velocity relationship have led some to assert that control of money growth is no longer a viable approach to monetary policy. This view is typically based on arguments about the pace of financial innovation and deregulation and the changing characteristics of money in our economy. Others have become impatient with controlling money growth because it seems abstract and removed from the very real economic problems we face, such as inflation, high interest rates or unemployment.

I think that we sometimes lose sight of why it is that we are so concerned about controlling the money supply. We do not seek to control money growth just to give the Federal Reserve something to do, or because it is an interesting exercise. Money growth is important because of its predictable long-run relation to the growth of nominal GNP, and its close correlation with the rate of inflation over the long run.

Effective monetary policy actions require only that there exist some economic variable -- be it the money supply, the monetary base, or the price of widgets -- that meets two conditions:

First, it must be controllable -- and ideally with some precision -- by the Federal Reserve. This condition eliminates a lot of potential candidates, including the price of widgets.

Second, it needs to be an economic variable that is related in a reliable way to the economic variables we ultimately wish to affect -- prices, output and employment growth.

While the money supply is not a perfect variable on which to base monetary policy, it is far more reliable and technically workable than most of the alternatives. With the exception of some measures of bank reserves and the monetary base, most of the alternative variables proposed as targets for monetary policy fail the first condition listed above, controllability. Interest rates, for example, are superficially an appealing variable for monetary policy -- in the sense that they are visible and easily understood by the public. The Federal Reserve cannot, however, control interest rates with an acceptable level of precision over the long run. Even if the Federal Reserve were able to control interest rates with reasonable precision, the relationship between interest rates and nominal GNP growth is not well understood or reliable. Without a dependable relation between the level or rate of change in interest rates and economic activity, interest rates do not provide the Fed with reliable information on when to change interest rates (if they could), or by how much, to have the desired effect on the economy. Furthermore, in the past, attempts to control interest rates have resulted in an inflationary bias in monetary policy.

Many people find the idea of using nominal GNP as a target for monetary policy to be appealing. A policy of controlling money growth, however, implies controlling nominal GNP growth because money growth and nominal GNP growth are closely related. In the case of monetary targeting, money growth is both the target for policy and the instrument of Fed policy actions. The Federal Reserve has no direct control over nominal GNP, so it is not a workable variable to use as a monetary policy instrument. Nominal GNP is, in effect, the ultimate goal or target of a policy of controlling the money supply; controlling money growth is a means by which nominal GNP growth is stabilized.

A central bank has no power to control real economic variables over the long run. Therefore real variables -- such as real GNP growth, real interest rates, the unemployment rate -- are also not viable targets for monetary policy actions. The only thing that a central bank can do over the long run is to assure price stability; that is accomplished by providing for an appropriate rate of monetary expansion. Beyond providing price stability, which can enhance real economic growth and financial market stability, a central bank can do nothing in the long run to promote employment, lower interest rates, or to stimulate higher real economic growth.

In addition to the monetary discipline they can impose, money growth targets can be an important short-hand description of the central bank's intentions with respect to future inflation. Once a tradition of setting and achieving credible money targets is established, the targets can also convey important information to the financial markets and investors. That information can contribute much to promoting financial market stability and reducing the uncertainty that surrounds investment decisions.

### The Long-Run Effects of Excessive Money Growth

It is a futile and ultimately self-defeating policy to use excessive monetary expansion in an attempt to drive interest rates down. In the long run, the results of that policy are just the opposite -- high, or rising, interest rates. Economic developments over the past two decades demonstrate the point that inflationary monetary policy yields not only more inflation, but less real growth, and higher unemployment and interest rates as well.

The table below provides long-term (5-year) averages for money growth, inflation, interest rates and real economic growth since 1960, plus the averages for 1981-82. As is shown in the table, the average rate of money growth has accelerated steadily since 1960. This rising trend of money growth has been associated with a similar acceleration in the average rate of inflation, as shown by the GNP deflator, and long-term interest rates, as represented by the Corporate AAA bond rate.

Note, however, that persistent monetary stimulus did not result in lasting economic growth. In the two decades from 1961 to 1980, the five-year average of money growth more than doubled, but average growth in real GNP declined. Furthermore, the average unemployment rate was more than a full percentage point higher in the 1976-1980 period than in the 1961-65 period. Thus, more than doubling the rate of money growth over the two decades did not "buy" us more real growth or less unemployment; it "bought" us higher inflation, and interest rates, and lower growth and higher unemployment. The inflation and high interest rates caused by prolonged, excessive monetary expansion are detrimental to real economic growth, and over the long run outweigh any short-run stimulus that may be induced by accelerating money growth.

Average Annual Rates of Change

| | M1 | GNP Deflator | Corporate AAA Bond Rate | Real GNP | Unemployment Rate |
|---|---|---|---|---|---|
| 1961-1965 | 3.5% | 1.6% | 4.4% | 4.7% | 5.5% |
| 1966-1970 | 5.0 | 4.2 | 6.4 | 3.2 | 3.9 |
| 1971-1975 | 6.1 | 6.6 | 7.9 | 2.6 | 6.1 |
| 1976-1980 | 7.4 | 7.3 | 9.4 | 3.7 | 6.8 |
| 1981-1982 | 6.8 | 7.7 | 14.0 | 0.1 | 8.7 |

## Where Do We Go From Here?

The task that now confronts the Federal Reserve is to achieve a gradual slowing in the rate of money growth and avoid any severe or prolonged period of excessive monetary restraint. Continuing to allow money to grow at an excessive pace will not produce the lower interest rates that all of us desire. With enormous uncertainty in the financial markets about monetary policy and the rise in long-term rates in the last months, the financial markets are likely to react adversely to a continuation of rapid money growth.

Those who oppose a slowing in the rate of money growth do so because they fear the rise in short-term rates that may accompany such a policy. It is likely, however, that any rise in rates associated with the slowing of reserve and money growth would be relatively short lived. Furthermore, short and long-term rates are already rising in response to the protracted period of excessive, above-target money growth. While the temporary rise in interest rates that may accompany a slowing of money growth is nothing to applaud, it is preferable to the permanent rise in long-term rates that can be expected if money growth continues unabated.

In the recent past, the effects of institutional change have generated considerable uncertainty and controversy about the behavior of the monetary aggregates. Those uncertainties have made it difficult to interpret the path of money growth in recent months. Some form of uncertainty is inherent in the process of conducting monetary policy, and risks are always associated with the alternative policy actions available to the Federal Reserve. The challenge for policymakers is to pursue policies that minimize the implied risk to economic performance and stability. My concern is that the path of money growth that has occurred in the last ten months does not represent a policy that minimizes risk. To the contrary, it is a highly risky policy, with the risk heavily skewed towards higher inflation and interest rates in the years ahead.

It is best that the Federal Reserve not attempt to reverse the recent surge in money growth as any severe or abrupt restriction of money growth would be damaging to the economy. What is needed is for the Federal Reserve to take the policy actions immediately required to provide a gradual slowdown of money growth.

It is vitally important that we remain sensitive to the danger of repeating the mistakes of the past when rapid money growth has been allowed to continue into the recovery phase, laying the groundwork for a renewed resurgence of inflation. Recognizing the lag in the effect of money growth on inflation, it is clear that if actions to slow the rate of money growth are delayed until an actual increase in inflation is observed, it will be too late to take the necessary preventive actions.

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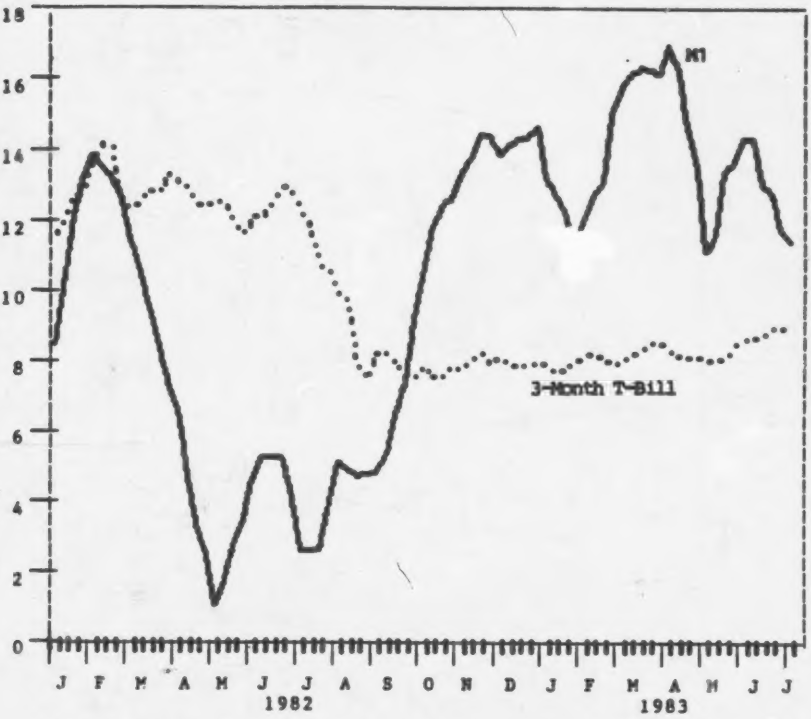
Chart 1

MONEY (M1) GROWTH AND SHORT-TERM INTEREST RATES
1982-1983

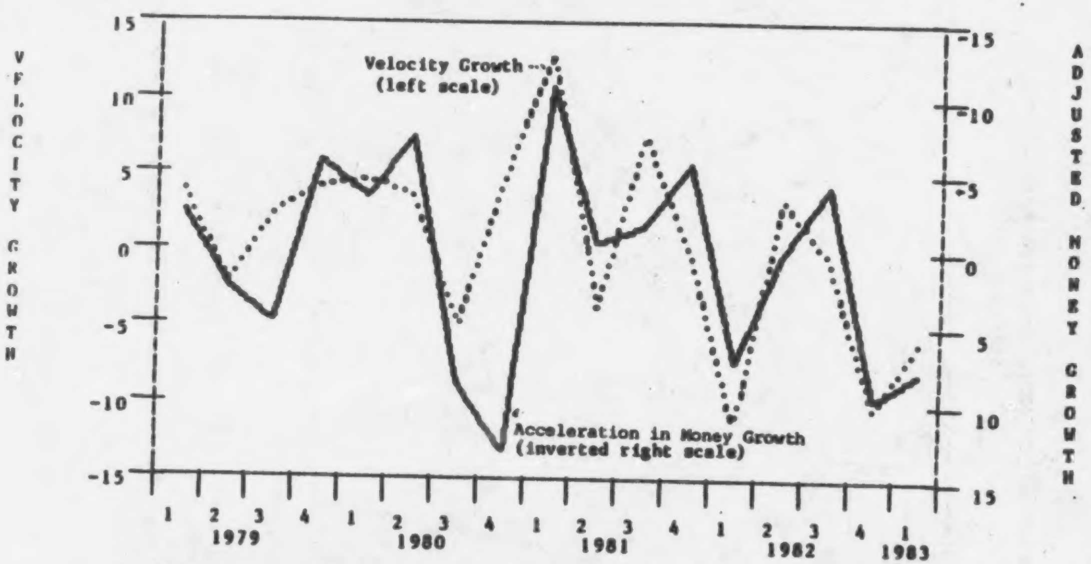


Note: data for M1 are four week moving averages; growth is relative to 13 weeks ago.

Prepared by the Office of Monetary Policy Analysis. Telephone 566-6261.

**CHART 2**

The Acceleration of Money(M1) Growth and Velocity
- 1979Q1 TO 1983Q1-
(ANNUALIZED PERCENT PER ANNUM)



*THE ACCELERATION OF MONEY GROWTH IS CURRENT QUARTERLY GROWTH LESS QUARTERLY GROWTH LAGGED TWO QUARTERS

VELOCITY GROWTH IS QUARTER TO QUARTER

Senator GORTON. Thank you very much, Secretary Sprinkel.

In February, Chairman Garn expressed a great deal of concern over the failure of short-term interest rates to fall in the fact of then-sharply declined inflation rates.

I'd like to followup with the questions he asked you then. In your view, is the current level of rates charged on short-term consumer loans consistent with the rate of inflation we've experienced for the first half of 1983?

Mr. SPRINKEL. Short-term real rates, if you measure real rates by actual inflation rates, appear very high.

I would also add that long-term rates, measured by current inflation rates, also appear high in terms of longer term history. I think it is mportant to note that we should not use the current rate of inflation to try to estimate real rates. What we should use is the expected rate of inflation over the period of time that the financial instrument is outstanding. The present actual rate of inflation is not too far off, probably, of the expected rate of inflation over the next, say, 6 months. But as you look at the longer-term instruments, it is very clear that the public does not believe that we in Washington will exert the necessary discipline to keep the inflation rate at present levels; that is, the real rate will come down with rising inflation. What we want is the real rate to come down, not with rising inflation, but through a decline in nominal rates.

Senator GORTON. There's no question about that, but should it affect short-term rates?

Mr. SPRINKEL. Not very much, because we are only talking about a brief period of time, and no one to my knowledge, that in the 6 months ahead there is going to be an enormous burst of inflation.

I think that part of it has to do with the uncertainty in financial markets stemming from volatile monetary policy. We did a study at the Treasury some months ago, measuring the effect of increased volatility of monetary growth, which has been evident since 1980, and the answers came up rather clearly that it added significantly to both the short-term rate and to the long-term rate.

You might say that Treasury bills do not carry much risk. But for many of the people that buy and sell Treasury bills, there is a lot of risk. You can lose millions of dollars in a short period of time if you are a dealer in Treasury bills and suddenly the rate moves against you; and therefore, it tends to result in dealers insisting on a higher rate of return in order for them to take that risk. So I think the volatility of monetary policy is part of it.

Also, on occasion, and this may be one of those occasions, there is a growing expectation that the Federal Reserve will slow the rate of growth in money. I expect them to do so. Certainly, the Chairman indicated they would do so. And again, when that expectation begins to develop, that tends to raise short-term rates. That should be a temporary phenomenon. If, in fact, there is a slow-down in money growth and if, in fact, we are successful in keeping the inflation rate down, it would be helpful if we had less volatility in money growth, which would also make it possible to get rates down to more reasonable real rate levels.

## TREASURY BORROWING WILL ABSORB SAVINGS

Senator GORTON. Mr. Secretary, I'm interested in your assessment of the actual degree to which Treasury borrowing to finance the deficit will absorb savings which would otherwise be available for investment. The projected 1983 deficit is now about $175 billion. The calendar 1983 gross private sector savings are estimated at about $544 billion. The capital consumption and allowances project a net private savings of about $178 billion. Abstracting from international capital it would appear that financing the government will absorb perhaps 100 percent of the net private savings of 33 percent of gross private savings.

Obviously, this situation sounds more serious when the Government deficit is compared to net private savings. Is this the appropriate comparison to be using? In other words, to what extent do depreciation figures represent real savings available for investment in productive enterprises?

Which comparison to gross or net savings gives a more accurate picture of Federal demand on our credit?

Mr. SPRINKEL. Well, in general, I hold firmly to the view that deficits compete for savings that would otherwise be available in the private sector. Fortunately, from one point of view, during a period like we have just gone through, when the budget deficit rose very substantially, it was accompanied by a reduction in the demand for credit in the private sector. There was inventory liquidation going on, there was a slowdown in capital investment; and those are not favorable trends.

We know if we are moving into a period of sustained economic growth, that short-term credit, and then longer term credit, demand from the private sector will be rising. It is during that period that I think it is very critical that we pull down the size of the Federal deficit, both in absolute amount, as well as relative to GNP.

I think that from the standpoint of money, moving from one type of investment into another, to the extent that we can create the prospect of low rates of inflation, there will be shifting from real assets to financial assets. This could have a favorable effect on interest rates, whereas it would have a not so favorable effect on real assets. If you look at the trends in inflation and what happens to real assets, real assets prices go up much more than inflation. That is, the name of the game a few years ago was to buy land, homes, gold, silver, commodities, you name it. And they didn't want stocks, and they didn't want bonds. But as inflation came down and inflation expectations came down, not as much as actual inflation, it has become very clear that commodity prices had moved down, dropping sharply. In many cases, home prices are no longer soaring. Paintings aren't doing very well. And investors are moving into financial assets.

I think it is an oversimplification to argue that you should look at either gross new savings or net new savings as the variable that is going to give you the clue as to whether or not we get interest rates down. We can get interest rates down in the period ahead with an expanding economic activity if we can gradually reduce the deficit and, at the same time, make more firm expectations that inflation will continue to go down. This will result in further shifts in the financial assets, which is where money goes when they expect inflation to be down and stay down. So I am not sure that either of those figures will give you a good clue if you're having major changes in inflationary expectations.

Senator GORTON. Next, would you comment on one of the questions I asked Dr. Feldstein, and that is the relationship between the value of the dollar as it moves up and down to our exports and imports, our balance of trade. How much can we expect to lose or how much can we expect to gain by even relatively small movements of the value of the dollar?

Mr. SPRINKEL. We also have some estimates—I heard Chairman Feldstein's response—and I will be glad to give them to you. I would be surprised if they are much different from his, but I have not seen his. The effect is not immediate, of course. It tends to work with a lag, and therefore it is our view that even if the dollar were weaker today it would not be a significant factor on our balance of trade until at least the latter part of 1984, not 1983. It takes quite some time.

It is true that relative real interest rates sometimes have an observable effect on the dollar exchange rates. It is also true that on other occasions it may be having an effect, but you can not demonstrate it. I think that is certainly too simplistic, and I am sure Marty would agree with me, to say that it is relative real interest rates alone that determine the value of the dollar vis-a-vis other currencies. For example, you often hear the argument that there is an important safe haven effect on the dollar; meaning by that, that we have a nation of political stability. When instability occurs abroad, money tends to move to the United States.

There are other reasons why money moves to the United States. They include the fact that we have open capital markets. Investors do not like to put money into an economy when there is a great risk that they will not be able to get an attractive return on that money, to bring money home, or to bring the money home in stock.

But also what I think is underemphasized is that the Congress and the administration, over the past 2½ years, have taken significant actions to improve the probability of high rates of return on investments in the United States: The tax cuts, encouraging savings and investments, the changes in the corporate income tax. We're now witnessing a very sharp increase in corporate profits along with previous sharp increases in equity prices. All of those factors have increased the value of the dollar.

There is a great tendency to compare the value of a dollar today with its low, which was achieved in the middle of 1980. But remember, 1980 followed a period of several years of very sharp inflation acceleration in the United States vis-a-vis the rest of the world. I would hope that we do not go back to out-inflating the rest of the world, and hence we are not likely to go back to as low a dollar as we had in July of that year.

There seems to be room over time for some gradual depreciation of the dollar, but I must say it is hanging very firmly. It depends partly on what other nations do. As long as we do a good job in keeping inflation under control, I would expect a reasonably strong dollar most of the time.

Incidentally, I would add that one of the very important responsibilities the United States should shoulder, in my opinion, is to try to maintain reasonable stability over domestic purchasing power of the dollar. The dollar is the kingpin in international finance, and if we have great volatility in our country, especially in a weakening direction, it creates great problems in the international financial arena.

I also realize that not only do foreign observers complain when the dollar is weaker, they also have been complaining recently when it was strong. But clearly, the fact that the dollar has been strong is going to lead to deficits in our monetary account; and certainly a greater one in our trade account. However, it does provide demand for goods in other countries, and could certainly help the worldwide recovery.

So I do not believe we should look at relative real interest rates as the only measured determinant for the value of the dollar vis-a-vis other currencies.

[Additional information supplied for the record by Mr. Sprinkel follows:]

## Effect of Changes in the Dollar Exchange Rate on the U.S. Merchandise Trade Balance

The U.S. merchandise trade balance is the net result of the effects of a number of economic variables on U.S. exports and imports. Generally economic growth at home and abroad, relative inflation rates, the stage of the business cycle here and abroad and exchange rates are major determinants of the trade balance. Other developments such as tariff or quota changes and expectations about future changes are sometimes also important factors in the growth of exports and imports.

The exchange rate of the dollar helps determine the price of exports and imports, and thereby can have important and sizeable impacts on the merchandise trade balance. Estimating the size and timing of these potential exchange rate impacts on exports, imports and the trade balance is difficult and complicated, and at best produces best guesstimates based on the relationships that have existed in the past.

On the basis of the Treasury Department's econometric work on the determinants of U.S. exports and imports, we estimate that the net long-run impact of dollar appreciation is to worsen the trade balance by $2.2 (annual rate) for each 1 percent the dollar appreciates on a weighted average basis against our major trading partners. These estimates would also suggest that dollar depreciation would improve the trade balance by the same $2.2 billion for each 1 percent fall in the dollar's value. These effects do not occur immediately. The response of exporters and importers to a change in the value of the dollar -- and hence in U.S. price competitiveness -- takes time to be realized in the form of new orders. As a result of this lagged response to an exchange rate change, the full impact is reached sometime between one and two years following the exchange rate change. While estimates of the length of this time lag vary, our own work suggests that it is seven quarters long.

According to our econometric work, the time paths of these impacts on exports and imports suggest that the effect on the trade balance will follow what is called a "J-curve" profile. That is, the trade balance initially moves in the opposite direction from its longer term path. In the case of a depreciation the trade balance initially worsens before it begins to improve. In the case of dollar appreciation, the initial impact (during the first two quarters) is to lower the dollar cost of imports (except oil imports), and hence to improve the trade balance.

However this "terms of trade" gain soon begins to be offset as both U.S. and foreign buyers react to the deterioration in U.S. price competitiveness resulting from the rise in the dollar. As a result, the volume of exports declines, and that of imports rises. In addition, the terms of trade gain itself starts to deteriorate as:

(a) U.S. exporters lower their prices in an effort to maintain market shares; while

(b) foreign exporters exploit their leeway to raise prices without serious loss of market share, causing some rebound from the initial drop in U.S. import prices.

By the end of the second year of a dollar appreciation, our econometric work would suggest that (at current levels of trade) the value of U.S. exports will decline by $2.0 billion for every 1 percent that the dollar appreciates. At the same time the value of U.S. imports will rise by about $200 million. These two effects, lower exports and higher imports, would jointly result in a worsening of the trade balance by some $2.2 billion per 1 percent dollar appreciation.

### MUST GET BETTER CONTROL OF OFF-BUDGET SPENDING

Senator GORTON. I have one last question, which Senator Trible has asked me to put to you.

We seem to be fixed on the Federal budget deficit as the major cause of our present problems. Bad as it is, the on-budget deficit isn't the total picture. We have a substantial amount of off-budget deficit spending by Federal loan guarantees with which we need to deal as well.

If we can't reduce the amount of budget deficit, can we get some of the same benefits by controlling off-budget spending and loan guarantees to a greater extent than we do at the present time? Isn't it really important to bring budget discipline to bear on these two areas by means of federal financing? Likewise, in connection with the Federal Financing Bank, by improving credit budgeting activities?

Mr. SPRINKEL. Yes; I certainly agree with that. However, I am not sure that I would argue that the principle problem is the budget deficit. That is, indeed, a problem, but I think the most important problem is Government spending. We had a persistent trend of allocating more and more resources to the Federal Government vis-a-vis the private sector. We came to this town with the hope and expectation that we could reverse that trend. So far, we have not been completely, but with the help of the Congress, we can be successful by controlling domestic spending, and also continuing to make progress in controlling off-budget items.

There are some serious additional borrowing requirements forced on the Treasury by the fact that their off-budget expenditures do not show up in the budget. We are strongly in favor, over time, of getting those off-budget items back on the budget, so the Congress and the administration can evaluate them, and perform a better job of controlling them than if they are hidden in an off-budget form.

As you know, in the past couple of years, there has been a reporting of the off-budget factors; that helps some, but we would still like to get them back on the budget.

Senator **GORTON**. Thank you very much. As you know, Senator Trible has introduced a bill on just that subject and has a great deal of interest in it.

Thank you very much, Mr. Secretary. We are very pleased to have had you with us this afternoon.

Mr. **SPRINKEL**. Thank you very much.

Senator **GORTON**. We now have a panel consisting of Professor Blinder and Dr. Meigs. If they will come forward, we will be happy to listen to them.

We apologize to them and to the Secretary for using up their whole day, when we had hoped to complete their work by noon.

Your statements will be incorporated in full. I appreciate your oral presentation. We'll hear from both of you.

## STATEMENT OF ALAN BLINDER, GORDON S. RENTSCHLER PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

Professor **BLINDER**. Thank you, Senator Gorton. Every time I testify on the subject, it seems that monetary policy is at a critical juncture.

That may be always true. It certainly seems to be true today. I'm going to paraphrase my statement and skip certain portions.

I come to you today as a representative of a majority group: people who are worried about what the Federal Reserve might do to us. Oscar Wilde once said that "experience is the name we give to our mistakes."

By this definition, the Fed has gained a great deal of experience in recent years. And I think we have some reason to fear that it may be about to gain more.

My testimony covers three questions that I presume to be of concern to this committee. First, given the large current and prospective budget deficits, what are the choices left open to the Federal Reserve?

Second, should the Fed take action to curtail the rapid growth of the monetary aggregates? And third, if the monetary aggregates are unreliable indicators, where can the Fed turn for guidance?

### LOWERING THE BUDGET DEFICIT

Given the lateness, I'm going to omit the third section of the testimony unless you have some questions.

Let me start with deficits. Realistically, the outlook is for very large deficits now, in the near term, and in the long-term future. Large deficits expand demand and put upward pressure on interest rates, leaving the Fed to choose between two rather unpleasant alternatives.

A tight monetary policy would counteract the expansionary effects of fiscal policy and push real interest rates even higher. Such high interest rates would certainly crowd out both business investment and homebuilding. If pushed hard enough, tight money can lead to recession.

An easy monetary policy on the other hand would limit the extent to which the large borrowing requirements of the Federal government drive up real interest rates.

Such an easy-money policy would lead to a stronger economy and a greater share of investment in GNP, which presumably are good things, but it would also probably lead to more inflation.

In my view, analysis of the risks involved in each scenario points overwhelmingly toward a mildly expansionary policy right now.

Consider what might happen if the Fed, goaded on by a perceived need to do something about the high growth rates of the money supply, hits the brakes too hard. The young recovery, which is still gathering steam and is rather fragile, could be stopped dead in its tracks and we could witness a third recession in the 1980's.

But this time the unemployment rate would not start from the 6.2-percent level in 1980, nor from the 7.2-pecent level in 1981, but from a 10-percent rate, which is awfully close to the highest we have experienced in this country since the Great Depression.

This scenario is horrible to contemplate, but unfortunately is not impossible. We should remember that after the 1980 recession the economy grew for only three quarters before a recession came again. And it was not some dark mysterious force that brough us back-to-back recessions but rather the excessively tight monetary policies of the Federal Reserve.

Lately we have been hearing so many rosey reports about the recovery that its strength and durability may seem beyond question. But I'd like to submit that it's not.

Much of the growth to date appears to have come from a swing in inventory behavior from a very rapid rate of liquidation at the end of 1982 to a very small rate of liquidation in the last quarter.

During the first quarter of this year real GNP grew at a 2.6-percent rate, but only half of that was in real final sales. In the last quarter, according to the preliminary numbers released this morning, real GNP grew at a healthy 8.7-percent rate, of which 5.5 was real final sales. The rest was inventory investment. And there will be more coming from inventories in the next quarter.

Interest rates have already risen enough to threaten the boom in housing. Net exports, as has been mentioned here several times, continue to be weak owing to our misalined exchange rates, and business investment remains weak owing to the great amount of unused capacity.

So what we have left propelling the economy upward is the Pentagon and the consumer. As far as the consumer goes, the savings rates that we've witnessed in the last few months are so low that I think everybody believes they are unsustainable and that rate of increase of consumer spending simply cannot be exected to continue. So the risks of clamping down too hard on money and credit are very real.

Now let us consider the risks in the easy money alternative. If the Fed eases up just as the economy is taking off on an exuberant boom, the result would be an excessively rapid recovery, bringing with it dangers of renewed inflation. No one would welcome this outcome after all we have been through.

However, since the boom would be starting from 10-percent unemployment and 75-percent capacity utilization, there is plenty of room for expansion before we begin to stretch our resources of labor and capital to the limits. So the Fed has a long time to recognize the error of its ways and to make adjustments.

A relapse into serious inflation seems highly unlikely. Instead the likely cost of a small error in the expansionary direction is a slowdown in the rate of progress against inflation.

So let me tote up the score. If monetary policy is too tight, there's a real danger of another recession. If monetary policy is too easy, the current progress against inflation could be arrested.

It would, of course, be best if the Fed would do exactly the right thing. Unfortunately none of us knows what exactly the right thing is and we must therefore consider it extremely likely that the Federal Reserve will gain more of what Oscar Wilde called experience.

In other words, we can't avoid the gamble, as much as it would be nice to avoid it. And to me it is clear on which side we should place our bets.

I would like to point out that I'm not suggesting a drastic change in the Fed's policy. My recommendation is merely that the Fed stop the upward creep of interest rates and perhaps nudge them down a little.

From reading his testimony to the House yesterday, and to the Senate today, I'm really not quite sure whether Chairman Volcker agrees or disagrees with this view of interest rates. There are paragraphs in that testimony that could be read either way.

Senator **Gorton**. That may very well be deliberate.

Professor **Blinder**. That may very well have been deliberate. I couch my recommendation in terms of interest rates, not in terms of any of the M's. That was deliberate.

Frankly, I neither know or care whether such a policy would mean faster or slower growth of $M_1$ or $M_2$ during the 6 to 12 months.

## GUIDES TO MONETARY POLICY

The Federal Reserve doesn't know either, but it does seem to care. In this section of the testimony I would like to point out and explain some of the dangers of using the M's as guides to monetary policy and, in so doing, I guess I will establish beyond a shadow of a doubt that those people that Secretary Sprinkel was just talking about are real—real people are saying these things.

In discussing targets for monetary policy, we should not lose sight of the fact that the M's are not goals in themselves but only instruments for controlling nominal GNP.

But nominal GNP growth is the sum of the growth rate of money plus the growth rate of velocity. If velocity growth slows, the money supply must grow faster or the economy will stagnate. If velocity growth accelerates, money growth should slow down.

The monetarist doctrine that monetary policy should be based on the M's is predicated on the belief that velocity growth is either stable or highly predictable.

A few years ago this doctrine may have been tenable. Now it is not. Deregulation and rapid financial innovation have radically transformed the ways people make payments and store their wealth, and continue to do so.

Whenever such changes affect the demand for any of the assets included in the M's, velocity shifts. And if such changes come in rapid succession, they will cause rapid and unpredictable shifts in velocity.

This is exactly what has happened in recent years, and is likely to keep happening.

Let me take as examples the high monetary growth rates that people have been talking about. Some of those numbers have been put on table 1 which follows page 6 in the testimony.

Since November 1982, $M_2$ has grown at a 16.3-percent annual rate, a sharp acceleration from the 9.2-percent rate recorded during the previous 12 months.

Does that signal a return to inflation? I don't think so.

Most of you will recall that a new type of bank account called a money market deposit account was authorized beginning in December 1982. Many people found this account an attractive new way to store their wealth and funds poured in.

Funds in those accounts now exceed $350 billion, having started from zero. You might wonder how a version of $M_2$ that excludes the money market deposit accounts would have behaved over the period since November 1982.

The answer is, as you can see on that table, that the annual growth rate of $M_2$, exclusive of MMDA's has been minus 20 percent.

So which is the right growth rate for $M_2$? Positive 16 percent growth rate or negative 20 percent?

I don't know and the Fed doesn't know. As a consequence, no one knows what to make of the reported growth rate of $M_2$.

The other perennial favorite monetary aggregate, $M_1$, began to accelerate a bit earlier than $M_2$, starting in June 1982. During the 12 months ending in June 1982, $M_1$ grew about 5½ percent. Then, from June 1982 to May 1983, $M_1$ grew at a whopping 13 percent annual rate, causing much consternation among monetarists.

Well, what happened? The story with $M_1$ is a bit less clear. Chairman Volcker in his testimony called attention to the NOW accounts and the super NOW accounts which bear interest, whereas $M_1$ didn't use to pay interest. These accounts are included in a component of $M_1$ which the Fed calls "Other Checkable Deposits." They're called OCD's in table 1.

You might be interested to note that the annual growth rate of these OCD's since June 1982 has been 41 percent. If we exclude OCD's from $M_1$ the recorded $M_1$ growth rate would have been only 6.4 percent.

That looks like a low number. On the other hand, had the Fed decided to put the MMDA's into $M_1$, which it very well could have done, the recorded growth rate of $M_1$ period would have been 102 percent.

Thus, depending on some subleties of definition, the Fed could have reported an $M_1$ growth rate anywhere between 6 percent and 102 percent.

There is obviously room for fun with numbers here. The point of taking you through them is only to show that monetary growth numbers are very liable to be meaningless in a period of rapid financial change.

Data on money supply are informative only if we also have a good understanding of what is simultaneously happening to money demand. But when there is rapid financial innovation, we simply have no such understanding.

If my arguments about financial innovation and the demand for money are correct, then the data should show that recent fluctuations in the growth of nominal GNP were dominated by velocity movements rather than by changes in the growth rate of money. Table 2 and figures 1 and 2 which follow in my testimony show that this is true.

A quick perusal of the numbers in table 2 leads, I think, to two conclusions. First, that quarter-to-quarter movements in nominal GNP show no resemblance whatever to quarter-to-quarter movements in money growth.

Second, that nominal GNP movements from quarter to quarter do show a striking resemblance to velocity movements.

Figure 1 which follows immediately after page 9, plots the growth rate of nominal GNP against the growth rate of $M_1$. It offers a convenient way to assess the monetarist position.

According to monetarism, changes in nominal GNP growth are dominated by changes in the growth rate of $M_1$. A monetarist would expect a close positive association with a slope near 1, indicating that each percentage point increase in money growth leads to 1 percent faster growth of nominal GNP.

Obviously, something has gone wrong. In recent quarters the relationship has actually been inverse. Nominal GNP grew slightly slower—I shouldn't say slightly, grew noticeably slower when $M_1$ grew faster.

Figure 2 which follows figure 1 offers a similar opportunity to assess an extreme antimonetarist view. According to this view, growth of $M_1$ is irrelevant to the growth of nominal GNP. I hasten to add that I am not advocating this extreme point of view.

Figure 2 plots the growth rate of nominal GNP against the growth rate of velocity, and there you can see a very strong positive relationship showing that the extreme antimonetarist view gets much more support from recent data than does monetarism.

My purpose in displaying these figures is not to argue that money growth has nothing to do with nominal GNP growth—though that happens to have been true for the last 2½ years—but only to illustrate how unequivocally the intellectual case for monetarism has evaporated in recent years under the pressure of financial innovation.

The moral of the story is clear: he who targets on the growth rate of money when velocity is behaving erratically is looking for trouble. And we have had some trouble in the last few years.

The last quarter of 1981 and the first quarter of 1982 illustrate just how bad things can get. During these two quarters, $M_1$ grew at a 7-percent rate, which sounds quite reasonable.

Unfortunately at the same time $M_1$ velocity fell at a 6-percent rate, leaving the annual growth rate of nominal GNP a scant 1 percent. The consequence was a 5-percent rate of decline or real GNP and a terrible recession.

History might well have repeated itself a year later had the Fed stubbornly adhered to the monetarist dogma. During the fourth quarter of 1982 and the first quarter of 1983, $M_1$ velocity fell at an 8-percent annual rate.

Fortunately, Chairman Volcker had renounced monetarism—temporarily, he said at the time—in October 1982, and $M_1$ was allowed to grow at a 14-percent rate. So disaster was averted.

Well, today there are voices urging the Federal Reserve to bring monetary growth rates back into line with the targets. If the Federal Reserve listens to these voices, it is flirting with danger. For as long as velocity keeps declining, seemingly high money growth rates are not only appropriate, but are actually essential if the recession is to be avoided. And I believe Chairman Volcker's testimony this morning recognizes this point.

As I said, the rest of the written statement has to do with alternative ways to target monetary policy.

Senator GORTON. Thank you.

[The complete statement follows:]

# MONETARY POLICY AFTER MONETARISM

Testimony of Alan S. Blinder, Gordon S. Rentschler Professor
of Economics, Princeton University, to the Senate Banking
Committee, July 21, 1983.

## 1. INTRODUCTION

Every time I testify on this subject, monetary policy seems to be at a critical juncture. Perhaps it always is. Anyway, this hearing is certainly no exception.

I come to you today as a representative of a majority group: people who are worried about what the Federal Reserve might do. Oscar Wilde said that experience is the name we give to our mistakes. By this definition, the Fed has gained a great deal of experience in recent years. And there is reason to fear that it may be about to gain more.

My testimony will cover three questions that I presume to be of concern to this Committee. First, given the large current and prospective budget deficits, what choices are left open to the Fed? Second, should the Fed take action to curtail the rapid growth of the monetary aggregates? Third, if the monetary aggregates are unreliable indicators, where can the Fed turn for guidance?

## 2. DEFICITS AND MONETARY POLICY

The Budget Resolution just passed by Congress projects a very large deficit for Fiscal 1984. And unless there is a radical change in fiscal policy, large deficits -- perhaps as high as 6% of GNP -- will persist into the future. Large deficits expand demand and put upward pressure on interest rates, leaving the Fed with a choice between two unpleasant alternatives:

ALTERNATIVE 1: The Fed can counteract the expansionary effects of fiscal policy by slowing growth of the money supply and tightening credit. A "tight money" policy of this sort, presumably embarked upon in the name of fighting inflation, would push interest rates even higher, and crowd out both business investment and homebuilding. If pushed hard enough, tight money can lead to recession, as has happened all too frequently in recent years.

ALTERNATIVE 2: On the other hand, the Fed can ease credit conditions in order to limit the extent to which the unusually large borrowing requirements of the Federal government drive up interest rates. Such an "easy money" policy would lead to a stronger economy and a greater share of investment in GNP. Unfortunately, it might also lead to more inflation.

Faced with this predicament, what should the Fed do? In my view, analysis of the risks involved in each scenario points overwhelmingly toward a mildly expansionary policy right now.

Consider what might happen if the Fed, goaded on by a perceived need to "do something" about the high growth rates of the Ms, hits the brakes too hard. The young recovery, which is still gathering steam and is rather fragile, could be stopped dead in its tracks. The third recession of the decade could follow. But this time the unemployment rate would not start the from 6.2% level of 1980, nor from the 7.2% level of 1981, but from a 10% rate -- close to the highest we have experienced since the Great Depression. An unemployment rate of 12% or 13% could easily result.

This scenario is horrible to contemplate. But it is by no means impossible. We should remember that after the 1980 recession the economy grew for only three quarters before recession came again. And it was not some dark mysterious force that brought us back-to-back recessions, but rather the excessively tight monetary policies of the Federal Reserve.

Lately, we have been hearing so many rosey reports about the recovery that its strength and durability may seem beyond question. But they are not. Much of the growth to date appears to have come from a swing in inventory behavior from rapid liquidation in 1982:4 to perhaps some accumulation in 1983:2. During the first quarter of 1983, real GNP grew at a 2.6% rate, but real final sales grew at only a 1.3% rate. Second quarter data were not yet available when I prepared this statement, but indications were that inventory movements played a major role in producing good growth in 1983:2.

Interest rates have already risen enough to threaten the boom in housing. Net exports continue to be weak owing to our misaligned exchange rate and to continuing recession in Europe. And business investment remains weak owing to the great amount of unused capacity. This leaves only the Pentagon and the consumer propelling the economy upwards. To my mind, this spells a fragile recovery. So the risks of clamping down too hard on money and credit are real indeed.

Now let us consider the risks in the easy money alternative. Suppose the Fed eases up just as the economy takes off on an exuberant boom. The result would be an excessively rapid recovery, bringing with it dangers of renewed inflation -- an outcome that no one would welcome. But how probable is this scenario, and how bad is the resulting inflation likely to be?

Suppose we really are on the verge of a strong and lasting recovery. Since the boom would be starting from 10% unemployment and 75% capacity utilization, there is plenty of room for expansion before we begin to stretch our resources of labor and capital. Specifically, it would take two to three years of real growth at a 6% rate before we began to approach the full employment zone, even using a rather pessimistic definition of full employment.

This means that the Fed has a long time to recognize the error of its ways, and to make adjustments, if it finds that it has embarked on an excessively expansionary policy. A relapse into serious inflation seems unlikely. Instead, the likely cost of a small error in the expansionary direction is a slowdown in our progress against inflation.

So let us tote up score. If monetary policy is too tight, there is a real danger of another recession. If monetary policy is too easy, the current progress against inflation could be arrested. It would be best, of course, if the Fed would do exactly the right thing. But, since no one knows what "the right thing" is, we must consider it extremely likely that the Fed will gain more experience. We have no choice but to gamble, and to me it is clear on which side we should place our bets.

I am not suggesting a drastic change in the Fed's policy. My recommendation is merely that the Fed stand guard against the upward creep of interest rates and perhaps nudge them down a little. Unfortunately, the Fed's recent pronouncements have pointed in the opposite direction.

## I. OPERATING PROCEDURES FOR MONETARY POLICY

In advocating a mildly expansive monetary policy, I have said nothing about how to translate such a vague directive into concrete targets for money growth. That omission was deliberate. Frankly, I neither know nor care whether such a policy means faster or slower growth of M1 or M2 in the next 6-12 months. The Fed doesn't know either, but it does seem to care. And, unfortunately, certain acts of Congress (such as the Humphrey-Hawkins Act) encourage an excessive preoccupation with the monetary aggregates. In this part of my testimony, I want to point out and explain the dangers of using the Ms as guides to monetary policy.

### VELOCITY, MONEY, AND GNP

In discussing targets for monetary policy, we should not lose sight of the fact that the Ms are not goals in themselves, but only instruments for controlling nominal GNP. We care about money growth only because of its presumed effects on the growth of nominal GNP. But nominal GNP growth is the sum of the growth rate of money plus the growth rate of velocity. If velocity growth slows, the money supply must grow faster or the economy will stagnate. If velocity growth accelerates, money growth should slow down.

The monetarist doctrine that monetary policy should be based on the Ms is predicated on the belief that velocity growth is either stable or highly predictable. A few years ago, this doctrine may have been tenable. Now it is not. Deregulation and rapid financial innovation have radically transformed the ways people make payments and store their wealth. Whenever such changes affect the demand for any of the assets included in the Ms, velocity shifts. And if such changes come in rapid succession, they will cause rapid and unpredictable shifts in velocity. This is exactly what has happened in recent years, and is likely to keep happening.

Let me take as examples the high monetary growth rates that have created so much controversy in recent months and have put pressure on the Fed to tighten up. (See Table 1.)

Since November 1982, M2 has grown at a 16.3% annual rate, a sharp acceleration from the 9.2% rate recorded during the previous 12 months. Is this cause to sound the inflationary

Table 1

Annual Growth Rates of Selected Monetary Aggregates

| | M2 | M2 less MMDAs | |
|---|---|---|---|
| November 1982 - May 1983 | 16.3% | -20% | |

| | M1 | M1 less OCDs | M1 plus MMDAs |
|---|---|---|---|
| June 1982 - May 1983 | 13.1% | 6.4% | 102% |

alarms? Hardly. Most of you will recall that a new type of bank account, called a money market deposit account (MMDA), was authorized beginning in December 1982. Many people found this account an attractive new way to store their wealth, and funds flowed in. Starting from zero in November, balances in MMDAs now exceed $350 billion. You might wonder how a version of M2 that excludes the MMDAs has behaved since November 1982. The answer is that the annual growth rate of M2 exclusive of MMDAs has been -20%!

So which is the "right" growth rate for M2, +16% or -20%? I don't know, and neither does the Fed. If all the funds that are now in MMDAs came from elsewhere within M2, then 16% would be the relevant figure. On the other hand, if all the funds in MMDAs came from assets not included in M2, then -20% would be more indicative of monetary growth. Obviously, the truth lies between these two extremes. But where? The sad fact is that we just do not know, and therefore cannot make any sense of the reported growth rate of M2.

The other perrenial favorite monetary aggregate, M1, began to accelerate a bit earlier, in June 1982. During the 12 months ending in June 1982, M1 grew 5.4%. Then from June 1982 to May 1983, M1 grew at a whopping 13.1% annual rate, causing much consternation among monetarists. What happened?

Here the story is a bit less clear, but December 1982 also marked the introduction of Super NOW accounts. These accounts, as well as the conventional NOW accounts, are included in a component of M1 which the Fed calls "Other Checkable Deposits." You may be interested to know that the annual growth rate of Other Checkable Deposits from June 1982 to May 1983 was 41%; if these were excluded from M1, the recorded M1 growth rate would have been only 6.4%.

On the other hand, had the Fed decided to put the MMDAs into M1, the recorded growth rate of M1 would have been 102%. Thus, depending on some subtleties of definition, the Fed could have reported an M1 growth rate anywhere between 6% and 102%.

There is obviously room for fun with numbers here. My purpose in taking you through them is only to show that monetary growth numbers are liable to be meaningless in a period of rapid financial innovation. Data on money SUPPLY are informative only if we have a good understanding of what is simultaneously happening to money DEMAND. But when there is rapid financial innovation, we have no such understanding.

## THE RECENT DOMINANCE OF VELOCITY MOVEMENTS

If my arguments about financial innovation and the demand for money are correct, then the data should show that recent fluctuations in the growth of nominal GNP were dominated by velocity movements rather than by changes in the growth rate of money. Table 2 and Figures 1 and 2 show that this is true.

Casual perusal of the numbers in Table 2 leads, I think, to two conclusions. First, that quarter-to-quarter movements in nominal GNP growth show no resemblance to quarter-to-quarter

Table 2

Quarterly Growth of Annual Rates (seasonally adjusted)
(in percentage points)

| Quarter | Nominal GNP | M1 | M1 Velocity | M2 | M2 Velocity |
|---|---|---|---|---|---|
| 1981:1 | 19.6 | 5.0 | 13.9 | 7.0 | 11.8 |
| 1981:2 | 5.3 | 9.2 | -3.6 | 10.3 | -4.6 |
| 1981:3 | 11.4 | 3.1 | 8.1 | 10.4 | 1.0 |
| 1981:4 | 3.0 | 3.3 | -0.3 | 10.0 | -6.4 |
| 1982:1 | -1.0 | 11.0 | -10.8 | 8.9 | -9.1 |
| 1982:2 | 6.8 | 3.3 | 3.4 | 7.2 | -0.4 |
| 1982:3 | 5.8 | 6.3 | -0.5 | 11.4 | -5.0 |
| 1982:4 | 2.6 | 13.7 | -9.8 | 9.6 | -6.4 |
| 1983:1 | 8.3 | 14.9 | -5.7 | 21.9 | -11.2 |

movements in money growth. Second, that nominal GNP movements do show a striking resemblance to velocity movements.

The two diagrams, which use the M1 concept of money, show these same conclusions graphically. Nine points are plotted in each diagram, one each for the nine quarters from 1981:1 through 1983:1.

Figure 1, which plots the growth rate of nominal GNP against the growth rate of M1, offers a convenient way to assess the monetarist position. According to monetarism, changes in nominal GNP growth are dominated by changes in the growth rate of M1. A monetarist would expect a close positive association with a slope near 1, indicating that each percentage point increase in money growth leads to 1 percent faster growth of nominal GNP. Obviously, something has gone wrong. In recent quarters the relationship has actually been inverse: during these 9 quarters, nominal GNP grew slower when M1 grew faster.

Figure 2 offers a similar opportunity to assess an extreme anti-monetarist view, far more extreme than anything I would personally advocate. According to this extreme view, growth of M1 is irrelevant to the growth of nominal GNP, which is instead controlled by changes in velocity. Figure 2 plots the growth rate of nominal GNP against the growth rate of velocity. A strong positive relationship is apparent, showing that the extreme anti-monetarist view gets much more support from recent data than does monetarism.

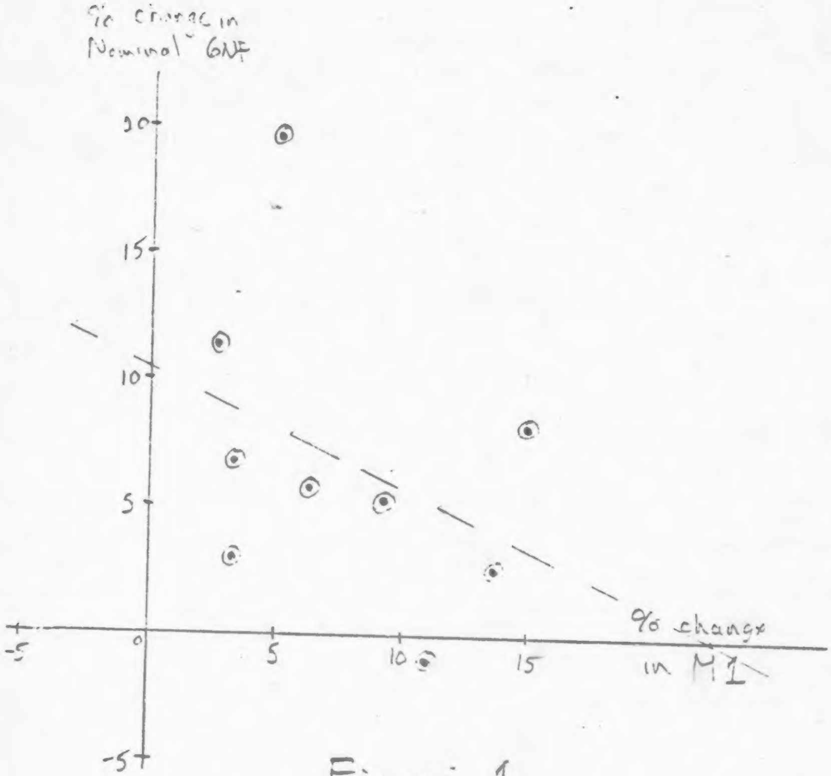


Figure 1
GNP and Money
1981:1 to 1983:1

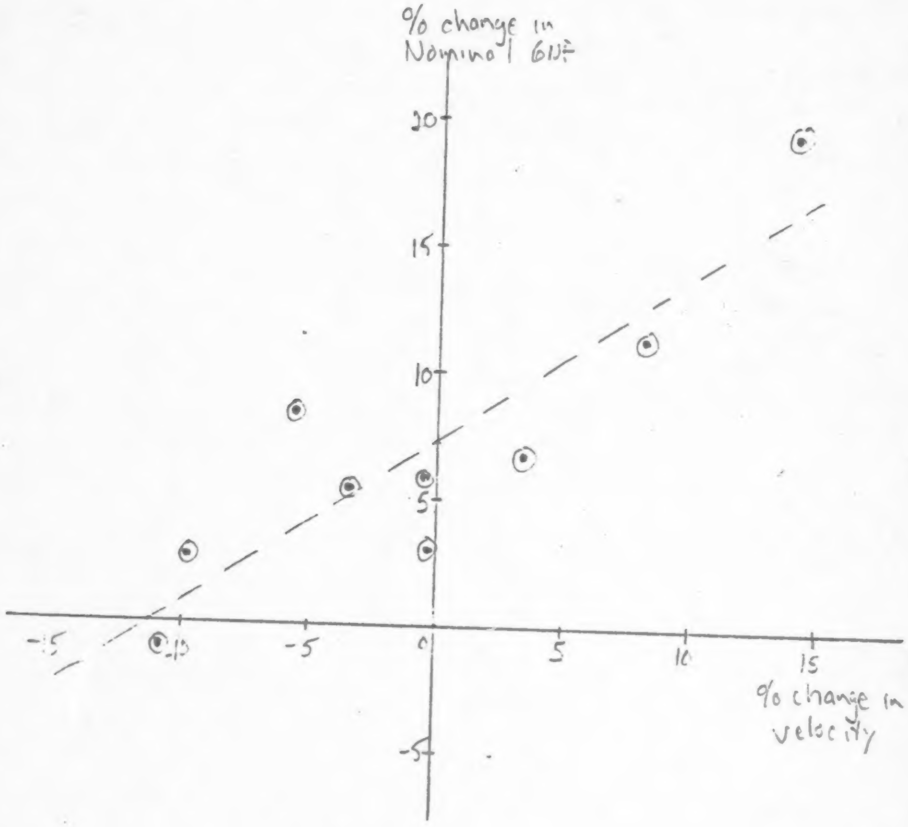


Figure 2
GNP and Velocity
1981:1 to 1983:1

My purpose in displaying these figures is not to argue that money growth has nothing to do with nominal GNP growth (though that has been true for the past 2 1/2 years), but only to illustrate how unequivocally the intellectual case for monetarism has collapsed.

## MONETARY POLICY AND MONEY GROWTH TARGETS

The moral of the story should be clear: he who targets on the growth rate of money when velocity is behaving erratically is looking for trouble.

The last quarter of 1981 and the first quarter of 1982 provide a vivid example of just how bad things can get. During these two quarters, M1 and M2 grew at 7% and 9.5% rates respectively. These sound like reasonable rates. Unfortunately, M1 velocity FELL at almost a 6% rate and M2 velocity fell at more than an 8% rate, leaving the annual growth rate of nominal GNP a scant 1%. The consequence was a 5% rate of decline of real GNP and a terrible recession.

History might have repeated itself a year later had the Fed stubbornly adhered to monetarist dogma. During the fourth quarter of 1982 and the first quarter of 1983, M1 velocity fell at an 8% annual rate and M2 velocity fell at a 9% rate. Fortunately, Chairman Volcker had renounced monetarism -- temporarily, he said -- in October 1982, and M1 and M2 were allowed to grow very rapidly (14% and 16% respectively). So nominal GNP was at least permitted to grow at a mediocre 5.4% pace. Real economic performance during these two quarters was not great; but neither was it catastrophic.

The application to the present situation is obvious. There are voices today urging the Fed to bring money growth rates back into line with targets. If the Fed listens to these voices, it will be making a grave mistake. For as long as velocity keeps declining, seemingly high money growth rates are not only appropriate, but are actually essential if recession is to be avoided.

## 4. GUIDEPOSTS FOR MONETARY POLICY

I have argued that the unpredictability of velocity renders monetary growth rates useless. So where should the Fed look for guidance?

When the thermostats in our homes work properly, we know how to use them. But when they malfunction, we ignore these mechanical devices and rely instead on our senses. The Fed should do the same. It should take its eyes off the defective monetary thermostat and look instead at what is going on in the economy.

### INTEREST RATES

Interest rates always carry a clue about what velocity is doing. If the Fed sets a monetary target and finds that interest rates rise unexpectedly, the evidence is pointing to falling velocity. The monetary growth target probably should be adjusted upward to compensate. Conversely, if the Fed finds interest rates falling unexpectedly, then velocity is probably rising and the monetary growth target should be adjusted downward.

If this sounds like a return to the old policy of short-run interest rate targetting, it should; because that's exactly what it is. The major justification for the 1979 change to short-run money targetting -- stable and predictable velocity -- has proven to be wildly incorrect. Unless and until velocity stabilizes, we should forget about money growth targets.

It is important to realize that short-run targetting on interest rates does not mean that interest rates should be pegged. Rather it means that the Fed should decide, in view of the needs of stabilization policy, where interest rates should be; then it should proceed to put them there.

## NOMINAL GNP TARGETS

Recently, many economists and members of Congress have suggested that the Fed adopt targets for nominal GNP instead of targets for money. Several bills to this effect are now pending in Congress.

In principle, targetting on nominal GNP is the correct solution to the problem of erratic and unpredictable shifts in velocity. For example, if velocity falls, a fixed nominal GNP target automatically calls for faster money growth. In practice, however, long-run targets for nominal GNP probably would require the Fed to formulate short-run targets for interest rates, as I have just suggested. An example will show why.

Suppose the Fed decides that it wants 8% growth of nominal GNP in a given year. To implement this decision, it must project the behavior of velocity, and then formulate a target for money growth accordingly. For example, if it expects velocity to grow by 2%, it will seek 6% growth of money.

But neither current nominal GNP nor current velocity are observed because of lags in the data. So we are always operating somewhat in the dark. As just mentioned, however, interest rates contain valuable and timely information about velocity. This information can and should be used to adapt the short-run money growth target to the long-run nominal GNP target, as described above.

Thus I conclude that short-run interest rate targetting is not something different from nominal GNP targetting. Rather, both are prongs of a coordinated policy.

## CREDIT AGGREGATES

Another recent suggestion has been to use a credit aggregate either to supplement or to replace the monetary aggregates. The credit aggregate most often discussed is Benjamin Friedman's concept of "net credit." Friedman found that the ratio of net credit to nominal GNP was remarkably stable from 1960 through 1980, and suggested that this ratio might provide a sounder basis for policy than the ratio of M1 to GNP (that is, velocity).

Table 3 contains some data relevant to this claim. It shows

Table 3

Annual Growth Rates of Monetary and Credit Velocities

| | Velocity of Money | | Velocity of Credit | |
|---|---|---|---|---|
| | M1 (1) | M2 (2) | Net (3) | Gross (4) |
| Historical (1960-1980) | +3.1% | 0 | -0.2% | -1.0% |
| Recent (1981:3 to latest)* | -4.0% | -6.5% | -5.6% | -4.6% |

* For money: 1981:3 to 1983:1

For credit: 1981:3 to 1982:4

the behavior of four concepts of "velocity," obtained respectively by dividing nominal GNP by M1, M2, Friedman's net credit, and a provisional measure of gross credit that I am developing in my current research.

Over the 1960-80 period, M1 velocity grew at a 3.1% annual rate while M2 velocity was constant. The recent behavior of monetary velocity, by either measure, has departed sharply from these historic norms. This, of course, is just a restatement of the unusual recent behavior of velocity that I have been emphasizing.

Column (3) shows similar data for Friedman's net credit. From 1960 to 1980, the velocity measure implied by his credit aggregate showed almost no trend. But in the last five quarters, this measure of velocity fell at a 5.6% annual rate. Thus, the break from historic norms in the behavior of Friedman's credit velocity is quite similar to the break in the behavior of monetary velocity, though slightly smaller.

Column (4) shows the corresponding figures for my measure of gross credit. From 1960 to 1980, credit velocity by this measure fell at a 1% annual rate. Over the last five quarters, it fell at a 4.6% annual rate. Thus the same qualitative break in behavior appears, but the departure from the historic norm is smaller yet.

These data show that measures of credit velocity have exhibited a recent break in behavior that is qualitatively similar to, but quantitatively smaller than, the break in the behavior of monetary velocity. Quarter-to-quarter fluctuations have also been less variable for credit velocity. Thus, if an intermediate target must be chosen, there is a case for choosing credit over money, though the choice of which credit aggregate to use is still an open question.

In my view, however, credit versus money poses a false choice because it is be better still to eschew all intermediate targets and focus instead on the things that really matter like interest rates, investment, inflation and real GNP. As Oscar Wilde might have said, the Fed should learn from its experience.

Senator **Gorton**. Dr. Meigs.

## STATEMENT OF DR. A. JAMES MEIGS, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, FIRST INTERSTATE BANK OF CALIFORNIA

Dr. **Meigs**. The first point, I'm concerned about the excessive growth of $M_1$ since June of last year. I attribute the surprisingly strong economic recovery to this sharp acceleration, which has fooled all the forecasters. But there has been enough monetary stimulus injected already, I believe, to raise the inflation rate 2 or more percentage points by the end of 1984. That is already built in. If we were to have another year of such very high money growth, I think the inflation rate would be over 10 percent by the end of 1985.

The second point. More inflation means higher interest rates. I don't have to dwell on the effects of a very sharp rise in interest rates over the next couple of years.

### REDUCE GROWTH OF $M_1$

So I urge your committee to support the Federal Reserve program to reduce the growth of $M_1$ without delay. In my written statement I suggest an 8-percent rate be adopted through the end of this year, which is inside the Federal Reserve's recommendation of 5 to 9 percent.

I would remind you that if they just hold to 9 or to 8 to the end of this year, by the end of the year we will have had a growth rate of over 11 percent for about a year and a half. That is very high.

Cutting back, of course, does raise some risks, it always does. One of the risks is that for a short time we will have higher interest rates, maybe for 6 to 9 months, as the Federal Reserve tries to slow down the growth to the money supply.

The second risk, any deceleration of money growth would cause a somewhat slower economic recovery, and as we have found many times in the past, too abrupt a slowdown could mean a new recession by 1984.

I still believe it is much better to start now than later. It is necessary to face a shortrun risk if we are to have in the longer run less inflation and lower interest rates and more growth in real income and employment.

I would like you to turn to the charts at the end of the statement because they summarize a great deal of useful evidence on money, interest rates, and inflation.

On the first chart we plotted the 3-month Treasury bill rates and the growth of $M_1$.

Because the Federal Reserve often says we should not pay attention to shortrun movements in $M_1$, we here have plotted the change in $M_1$ over the previous 12 months in the belief that 12 months movement in one direction is significant, as Chairman Volcker has said many times.

One thing that is very clear on this chart is that every time the growth rate of the money stock increased interest rates went up later, several months later. Every time the money growth rate decelerated or fell, bill rates fell later.

Most of us were taught in economics textbooks to expect just the opposite to happen, but the experience in financial markets since the 1960's should cause some rewriting of the textbooks.

The second point, over the whole 20-year period, doubling the money growth rates meant the doubling of interest rates.

It is very interesting that today Mr. Volcker, Mr. Feldstein, Mr. Sprinkel all made the same points, some of them using almost the same charts.

There is one not so little problem. You will notice that rates generally continue to rise for a while in each case after money growth decelerates. I think that is one of the reasons why there is so much concern that slowing down money growth is going to cause higher interest rates.

In my view, the main reason for the rise in interest rates persisting is because of the preceding acceleration in money growth, not the slowing down.

The next chart is another very familiar chart to all of us. Here we plotted current inflation against money supply growth 2 years earlier. That is because in general money supply growth rates affect the inflation rate with about a 1½- to 2-year lag.

On this chart we simply shifted the money growth rate series 2 years to the right. So if you look at, say, the inflation peak in 1974, it is matched on that chart with the money growth peak of 1972, 2 years earlier.

What is striking on this chart is that each upsurge of inflation coincides with an upsurge in money growth which happened 2 years before, and each fall in inflation rate coincides with a fall in money growth, which also happened 2 years before.

My conclusion is the Federal Reserve has to reduce the growth of money supply in order to reduce the inflation rate and also to reduce interest rates.

The first chart demonstrates that the Federal Reserve cannot reduce interest rates by increasing the growth of money supply. They can only be successful in this for a very short time. I work in the financial markets, and I would consider that short time almost down to a few minutes.

The alarming thing on both of these charts is the period of money growth rates on the far right, that is, over the preceding year. On the interest rate chart it would suggest that interest rates will go up some more this year before they can turn down, even if the Federal Reserve is successful in curbing the growth of money supply very soon, and that is a debatable question.

And then on the inflation chart, the rise in money growth there is plotted for the years 1984 and 1985, and you see the very, very steep rise in the money growth there. There is nothing like it until you go back to the year 1944 in our history of the United States.

So that suggests there is a very significant inflation danger for 1984 and 1985 unless something is done. So I would say the Federal Reserve does have a problem. If they want lower inflation, I do believe they will have to quell a new outbreak of inflation before they can extend the downtrend of inflation that was underway in 1982-83.

Now to the question of targets, $M_1$ or $M_2$ or interest rates. Much has been said about the effects of deposit rate deregulation on $M_1$. There are two general views.

One I would say is sort of the Federal Reserve view. It has much support from outside economists. This view is that changes in the interest paid on deposits makes people want to hold more $M_1$. I accept that. Then holders of this view go on from that to say that explains why $M_1$ grew so fast.

The second conclusion is that this new $M_1$ that is paying interest has less kick than old $M_1$. So I would suggest if you hold that view you may wish to call this decaffeinated $M_1$. The second—oh, yes, with the decaffeinated $M_1$ you don't need to worry about inflation in cases of very high growth in this $M_1$.

The second view, which I would call the monetarist view, and not all monetarists hold this—I would be honest with you on that—has two parts: First, that $M_1$ has simply not been distorted nearly as much as some of the popular discussions would lead one to believe. I work in a bank. I can see what goes on.

The variable that has really been distorted is $M_2$. $M_2$ is vastly different from what $M_2$ was 2 years ago, because $M_2$ now carries the counterpart of money market mutual funds, which are not very closely related to the GNP or anything else.

It is very interesting that the Board itself is now coming to the same view in their midyear report in which they say that $M_1$ has not really been distorted in the year 1983. Also, I noticed that Chairman Feldstein made the same point, that the distortion of $M_1$ is simply not true.

The second point about this is that the nature and characteristics of $M_1$ have changed, that is, now they pay interest. I would say, yes, that might well account for some increase in $M_1$. It might cause, for a time, a slowdown in the growth in velocity of $M_1$. But no matter how much you believe that, it is very hard to believe that it is enough to offset a 13- or 14-percent growth of $M_1$ in a year.

The contest between the two views—and I think Beryl Sprinkel referred to this—is an empirical question. It will be a while before we know for sure, but I would suggest to you that the way the economy is behaving is providing more support for the second view than for the first. That support is in two parts.

One is the behavior of interest rates. Financial markets are behaving as though $M_1$ is still important. $M_1$ matters to financial markets.

The second part, the very strong economic recovery, is consistent with the view that a big acceleration of $M_1$ would cause a rise in economic activity 6 to 9 months later. We are certainly having that. Many holders of the first view about the nature of $M_1$ being so changed it is no longer any guide to policy, were forecasting a very anemic recovery until very recently.

I say there is not much time left on the other side to argue that we should abandon what we have learned from the experience of hundreds of years on the strength of suppositions about some new characteristics of money.

## IMPORTANCE OF CURBING MONEY GROWTH NOW

A couple of points: Why do it now? Why curb money growth now rather than later?

We now have some favorable circumstances. Chairman Volcker alluded to that several times. You know, the inflation rate is low now; we have very large stocks of commodities and very large crops coming on; and no OPEC oil shock is likely.

That gives us perhaps 1 or 2 years grace period in which to work on this problem of potential inflation in the future. But I would suggest to you that there is not time to waste.

One way to see that is to look at 1976 and 1977.

You can see on the inflation chart that inflation accelerates well before the economy approaches the zone of full employment. Inflation tripled within 2 to 3 years, twice in the decade of the 1970's. So inflation could come back with a rush. It is not something that is very slow moving and slow to respond to monetary forces, especially now when consumers, managers, and investors have become aware of where inflation comes from, are very sensitive to it, and sensitive to changes in Government policy, which would suggest to them there is going to be more inflation in the future. That changes their behavior in all kinds of markets.

I want to say something about this issue of the coordination of monetary and fiscal policies.

You hear a lot about the problems that the budget creates for the monetary authorities. Every Federal Reserve Board Chairman comes to these committee hearings to lecture you on budget deficits and so forth, because these are safely out of their control. They do prefer to talk about budget policy and the difficulty it creates for monetary policy, but I would say it is a two-way street.

I assert that you cannot have a good budget policy unless you have a good monetary policy. By good monetary policy I mean one of getting inflation down and keeping it down so that you have a stable monetary framework, you have a stable price level. I would say that you could request the Federal Reserve to pursue such a policy simply to get inflation down and hold it down so that you could create a budget policy with much better ability to predict costs of programs, to predict revenues. Your budget would be less distorted by an alternation of recessions and inflationary booms.

So that completes my statement. I will be happy to answer any questions.

[The complete statement follows:]

# STATEMENT PREPARED FOR HEARINGS BEFORE THE SENATE BANKING COMMITTEE

July 21, 1983

By A. James Meigs
Senior Vice President & Chief Economist
First Interstate Bank of California

It is a privilege for me to appear before this committee when you are considering matters of such crucial importance to the future stability and prosperity of the U.S. and world economies. Monetary economics and monetary policy have been my principal research interests since I joined the Federal Reserve Bank of St. Louis in August 1953. Now, as Chief Economist of First Interstate Bank, I see daily evidence of how sensitive world economic conditions and financial markets are to changes in U.S. monetary policies.

The sharp acceleration in growth of the money supply over the past year is the main reason the economic recovery is suddenly exceeding practically all of the governmental and private forecasts that were published during 1982. The boost to economic activity and employment is welcome, but it may prove to be a costly one. Enough monetary stimulus has already been injected to raise inflation two or more percentage points by the end of 1984, I believe. If monetary expansion were to continue for another year at the rate of the past year, inflation would rise to more than a 10% annual rate by the end of 1985.

Well before such a rise in inflation reached its peak, both long-term and short-term interest rates would rise by comparable amounts, because world financial markets are now extremely sensitive to signs of future inflation. We need not dwell here on the damage a, say, five-percentage-point rise in interest rates could do to financial intermediaries, including banks and savings institutions, to interest-sensitive activities, such as homebuilding, auto sales, and business investment in plant and equipment, and to the less-developed countries that are having trouble with their debts.

I urge you, therefore, to support a Federal Reserve policy of reducing monetary expansion without delay. The annual growth rate of M1 should be reduced immediately to 8%, in my opinion, and held there through the second half of this year. Thereafter, money growth should be reduced in small steps until it reaches a rate that would produce a zero inflation rate.

There will never be a better time to begin. I say this knowing that slowing monetary expansion after an acceleration such as the one we have seen over the past year will present two painful, but probably unavoidable short-run risks:

1. With the Federal Reserve's current monetary control procedures, an effort to curb monetary expansion could drive the federal funds rate and other short-term rates higher for as long as six to nine months.
2. A slowing in monetary expansion would slow the pace of economic recovery. Slowing too abruptly could lead to a new recession.

As I suggested earlier, the longer the Federal Reserve waits to face these risks, the more serious they will become. But facing these short-run risks is essential if we are to have less inflation, lower interest rates, and more growth in real income and employment in the long run. I agree with Chairman Volcker's comment before this committee on July 14 that "Sometimes a restraining action in the short run may avoid the need for much larger actions later."

In the rest of this statement, I offer for your consideration a review of choices available to the Federal Reserve, some reasons why conditions are more favorable for a change of course today than they would be later, and some comments on the coordination of monetary and fiscal policies.

## Choices Available to the Federal Reserve

Interest Rates. The monetary authorities, like everyone else, would like to see interest rates fall. But as Chairman Volcker and other Federal Reserve spokesmen have explained many times, the Federal Reserve cannot reduce interest rates simply by increasing supplies of bank credit and money. To the contrary, an attempt to do so under the conditions the System faces today would at most delay the rise of short-term rates and would mean higher rates later. The only way the Federal Reserve can reduce interest rates and keep them down is to reduce inflation and inflation expectations. That would require reducing growth of bank credit and the money supply, not increasing it.

During the early stages of a Federal Reserve policy of reducing money growth rates, short-term interest rates would actually rise for a time. That surely would raise a storm of criticism from people who do not understand the market constraints within which monetary policies must operate. Nevertheless, many people in financial markets do understand the linkages among monetary expansion, inflation, and interest rates, which is one reason interest rates have been rising in recent months in the face of high rates of monetary expansion. In effect, financial markets are both anticipating and demanding some action from the Federal Reserve to slow the pace of monetary expansion. Recent high rates of monetary expansion have been pushing interest rates upward in two ways:

1. Experienced lenders and borrowers in financial markets expect high rates of monetary expansion to mean higher inflation rates later and so they take action to protect themselves against higher future inflation. These responses tend to raise long-term interest rates.
2. Expecting the Federal Reserve to curb monetary expansion sooner or later, lenders and borrowers in the money market respond to announcements of high money-growth rates by trying to protect themselves from the increase in interest rates that they think must come when the Federal Reserve clamps down. That is why the announcement of a surprisingly large increase in the weekly-average money supply on a Friday afternoon usually will drive interest rates upward within a few minutes after the news gets on the wires.

Chart 1 demonstrates how futile it would be now for the Federal Reserve to try to hold interest rates down by increasing growth of the money supply. It shows twelve-month rates of change in M1 -- to avoid over-emphasizing the influence of short-term changes in money supply -- on the solid line and monthly-average three-month Treasury bill rates on the dashed line. Each sustained rise in M1 growth over the two decades covered was followed within a few months by a rise of interest rates, although most of us had been taught in economics textbooks to expect just the opposite to happen. Each sustained decline in M1 growth was followed by a fall of interest rates.

As the ranges of money-growth rates rose, over the long period covered in Chart 1, so did interest rates. Between the first half of the 1960s and the second half of the 1970s, a doubling of average M1 growth rates was accompanied by a doubling of average Treasury bill rates.

It is also clear from the chart that interest rates usually continued to rise for a time after money-growth rates turned downward and continued to fall for a time after money-growth rates turned upward. This helps to account for the fears that a shift to monetary restraint now will mean higher rates. The view I present here would place more emphasis on the preceding monetary acceleration than on monetary restraint as the cause of rising interest rates. The large rise in M1 growth from June of last year through June of this year, for example, suggests that interest rates should continue to rise for several months more, even if the Federal Reserve succeeds in turning the money-growth rate downward soon. The rise of roughly 150 basis points in bill rates between October of last year and today is consistent with this explanation. Forecasters who believe that rates instead will fall in the second half of this year must implicitly assume that people in financial markets will interpret this latest upsurge in growth of M1 differently than they did the earlier ones shown on the chart.

Inflation. Bringing inflation down from a peak twelve-month rate of nearly 15% in early 1980 to 3.5% in May of this year was a stunning achievement. Yet it seems neither likely nor desirable that the Federal Reserve would settle for a 4%-5% inflation rate as the best that could be done from now on. The Chairman has declared his determination to continue the fight against inflation. However, I am afraid the Federal Reserve will have to quell a new outbreak of inflation over the next two or three years before it can extend the downtrend in inflation that was underway between 1980 and mid-1983.

On Chart 2, we have plotted twelve-month rates of change of the Consumer Price Index with changes in M1. Because changes in M1 affect inflation with about a two-year lag, we shifted the money-supply series two years to the right. Thus the inflation rate for 1980 is matched on the chart with the M1 growth rate for 1978, two years before, that helped to determine it. It is easy to see in this way that each major upsurge of inflation on the chart coincides with an upsurge in growth of M1 that happened two years earlier. Each fall in inflation coincides with a fall in money growth that happened two years earlier.

What this chart implies for inflation in 1984 and 1985 illustrates the policy problem the Federal Reserve faces now. The rise of M1 growth from mid-1982 through mid-1983 (plotted in mid-1984 to mid-1985) indicates the direction, if not necessarily the magnitude, of changes in inflation rates to follow in 1984 and 1985. The OPEC oil-price shocks of 1973 and 1979 contributed to the height of the 1974 and 1980 inflation peaks and the fall of oil prices this year brought inflation to a lower level than would be indicated by monetary influences alone. Nevertheless, it is evident that monetary accelerations and decelerations preceded and dominated the swings in inflation rates.

All of the evidence we have from the history of the United States, as well as the experience of many other countries, indicates that an acceleration of monetary expansion lasting as long as a year will have a significant impact on prices a year-and-a-half to two years later. We know nothing yet that would invalidate that evidence. Therefore, I believe inflation will be higher in 1985 than it is today, even if the

Federal Reserve has already begun to moderate growth of the monetary aggregates. How much higher inflation will be in 1985 will depend in part on when and how the Federal Reserve acts to slow monetary expansion. The monetary authorities have no other choice but to reduce money growth if they are to control inflation.

Targets: M1, M2, MX, or Interest Rates? The introduction of new forms of interest-paying deposits, such as NOW accounts, money market deposit accounts, and Super NOWS, certainly has complicated problems of interpreting reported changes in the monetary aggregates. The changes in deposit regulations enter the interpretation problem in two main ways:

1. To explain why M1 and the other aggregates have grown so rapidly over the past year.
2. To explain how changes in M1, M2, and other aggregates should be expected to influence economic activity, inflation, and interest rates differently than they would have before deregulation.

These are complex, difficult problems and probably will provide major research topics for years to come. But people with management decisions to make in government, business, and in their own households cannot afford to wait for a long period of consumer testing of these new monetary aggregates before deciding what to do. At the risk of over-simplifying, therefore, I would like to discuss two main approaches to the interpretation problem.

The first is my approximation of the Federal Reserve System's current view. It has the support of many economists outside the System as well. According to this view, the payment of interest on deposits included in M1, combined with a general desire to be more liquid, has made people want to hold more M1. This increase in demand for M1 is said to explain why M1 has grown so much. It also implies that a given increase in what we might now call decaffeinated M1 would have less influence on economic activity, prices, and interest rates than the same increase in old M1 would have had. Holders of this view are not as much disturbed by the high rate of growth of new M1 shown on the charts over the past year as they would be if they thought it was as potent as old M1. Although the other monetary aggregates have also been made more attractive by deregulation and have also grown rapidly since last year, their recent performance is considered to be satisfactory; or at least not far enough out of line to cause inflation and interest rates to rise. Until very recently, holders of this view have been forecasting an anemic recovery in economic activity, a stable or falling inflation rate, and falling interest rates.

The alternative view, held by some but not all monetarists, is that the acceleration in growth of the monetary aggregates was not produced by distortion of M1 or by an increase in the demand for money but rather by an apparent return by the Federal Reserve to its pre-October, 1979 procedures of controlling monetary growth through pegging federal funds rates or net borrowed reserves. When total private and governmental demands for credit rise, as they have since last year, or are expected to rise, an attempt by the Federal Reserve to moderate increases in federal funds rates or net borrowed reserves leads to increasing open market purchases of securities, faster growth of bank reserves and the monetary base, and faster growth of M1, M2, and other higher order Ms. This is still a matter of conjecture, until we have a more detailed explanation from the monetary authorities, but there is some support for it in the Federal Reserve Bank of New York report, "Monetary Policy and Open Market Operations in 1982." The report refers to M1 increases exceeding projections in September, October, and November of last year. Such overshooting of targets in the past has been attributed to the inability or unwillingness of the Open Market Committee to adjust federal-funds-rate targets quickly enough to keep money growth on track.

The monetarist view concedes that payment of interest on deposits included in M1 may have increased demand for M1 enough that a given change in M1 would have less influence on economic activity, prices, and interest rates during the period in which the new forms of deposits were being introduced than it would have had before deposits bore interest. However, a 13%-14% increase in M1 in a year is too much for its effects on economic activity, prices and interest rates, to be completely or largely offset by an increase in the demand for M1, in this view. It should also be noted that the introduction of money market demand accounts (MMDAs) early in this year, has exerted a dampening effect on the demand for M1. The new accounts provide incentive for people to shift funds from NOW accounts, in M1, to MMDAs, in M2, in order to earn higher rates. Most monetarists, therefore, have been forecasting a strong economic recovery and higher interest rates this year and more inflation in 1984 and 1985.

Only time will tell which of these two views will provide the most reliable guide to monetary policy and to decisions in businesses and households. However, there are two main types of evidence to suggest that the traditional monetarist view is likely to prevail.

The first of these is the behavior of financial markets. Interest rates are behaving as though lenders and borrowers in financial markets still believe M1 is important. This can be seen in the rises of interest rates and falls in bond prices and stock prices in recent weeks.

The other main evidence is in the strong economic recovery. Economic activity is increasing about as monetarist forecasters would have predicted if they had known how much M1 was going to grow. Many, however, had expected the Federal Reserve to keep money growth closer to its announced target rates and so actual growth in economic activity and employment has exceeded their forecasts, too.

Why Do It Now?

There is an understandable temptation for all of us to shrink from the costs of curbing inflation. The costs of the battle since 1979 have been very high all over the world. But, if inflation is allowed to return to double-digit rates, it will be even more difficult to cure next time.

Fortunately, the initial conditions are much more favorable for a program of reducing monetary expansion today than they were in 1979. In the first place, inflation is running at less than 5% per year in the United States and is down considerably from past peaks in all other major industrial countries. The likelihood of another oil-price shock is low. Stocks of agricultural and other commodities are high and this year's crops are again likely to be large, according to early indications. Many business firms are poised to reap large productivity gains as a result of measures they took during the recession. And deregulation promises more competition and even price reductions in some industries.

These favorable initial conditions by no means guarantee that getting money growth back under control will be painless. But they will provide a year or two of more favorable circumstances than would be encountered if the Federal Reserve is persuaded to delay taking action. It is sometimes believed that such favorable conditions would provide a much longer period of security from inflation threats than one or two years. That was the mistake made in 1976 and 1977, when apparent slack in the economy seemed to promise abundant room and time for applying stimulative policies. As can be seen on the inflation chart, however, inflation can return with a rush. Inflation tripled within two to three years twice during the decade of the 1970s. There is no time to waste.

## The Coordination of Monetary and Fiscal Policies

There has been a seductive notion for some time that monetary policy and fiscal policy are easily substituted for one another. Therefore, a country that would like to enjoy low interest rates and price stability at the same time could combine an easy monetary policy with a restrictive fiscal policy. Or if it wants to stimulate demand without depressing interest rates it could combine a restrictive monetary policy with an expansive fiscal policy. Unfortunately, it has not been demonstrated in any country that either of these mixes would work in the way intended.

We have already seen on Chart 1 that the Federal Reserve cannot reduce interest rates by increasing monetary expansion. If it is feared that rising government spending and budget deficits raise interest rates, there is nothing the Federal Reserve can do about that, except to hold inflation and inflation expectations down by controlling growth of the money supply.

Substituting monetary policy for fiscal policy, or vice versa, or elaborate devices for coordinating the two are not the answers to improving government's contribution to the performance of the economy. Both have vital roles to perform and each would be made more effective by a reduction of instability in the other.

It is often charged that the irresponsible fiscal policies of politicians make it impossible for their more sober central-bank brethren to conduct proper monetary policies. But it also can be argued that the failure of the monetary authorities to use their powers to best effect makes it extremely difficult for governments to maintain appropriate fiscal policies. By appropriate fiscal policies I mean spending and tax policies that are determined by the conscious choices of the electorate, rather than by accidental effects of recession and inflation.

Neither fiscal nor monetary policy is suitable for short-run stabilizing operations, despite the many recommendations that either or both be made more flexible. Financial markets and markets for goods and services would work better if they could be assured of stable, dependable fiscal and monetary policies for years ahead.

Avoidance of federal deficits when the economy is fully employed and of sudden swings in expenditures would vastly simplify the problems of the monetary authorities. The central-bank practice of helping treasuries sell new debt even when this help seriously impairs monetary policy grew out of the fact that fiscal policies have been poorly managed in most countries for longer than anyone can remember.

Monetary policy can make its greatest contribution to the budget process by reducing inflation and keeping it down. That would have a direct benefit in reducing the carrying costs of the public debt. And, more important, it should greatly increase the ability of all units of government to estimate future costs of programs and to predict revenues. The government, like businesses and households needs a stable monetary framework and a stable price level to maximize productivity and efficiency in delivering services. Therefore, I repeat my recommendation to this committee to support a Federal Reserve policy of reducing monetary expansion without delay.

THREE-MONTH TREASURY BILL RATE AND GROWTH OF M1

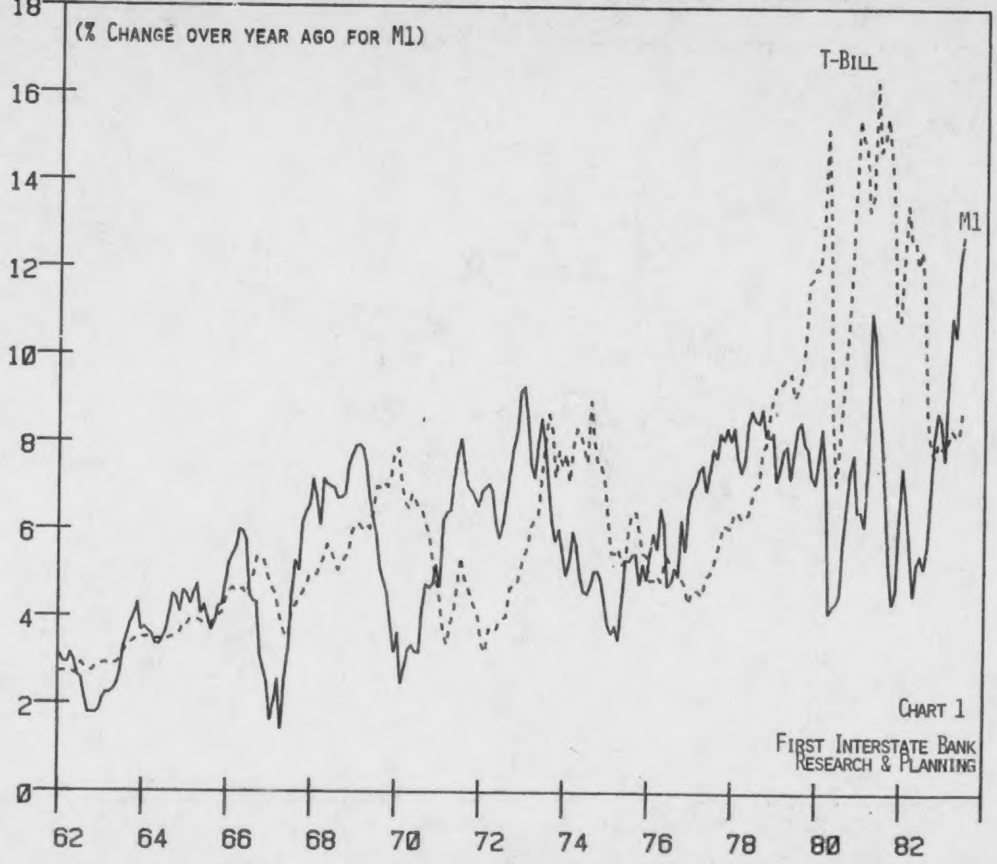
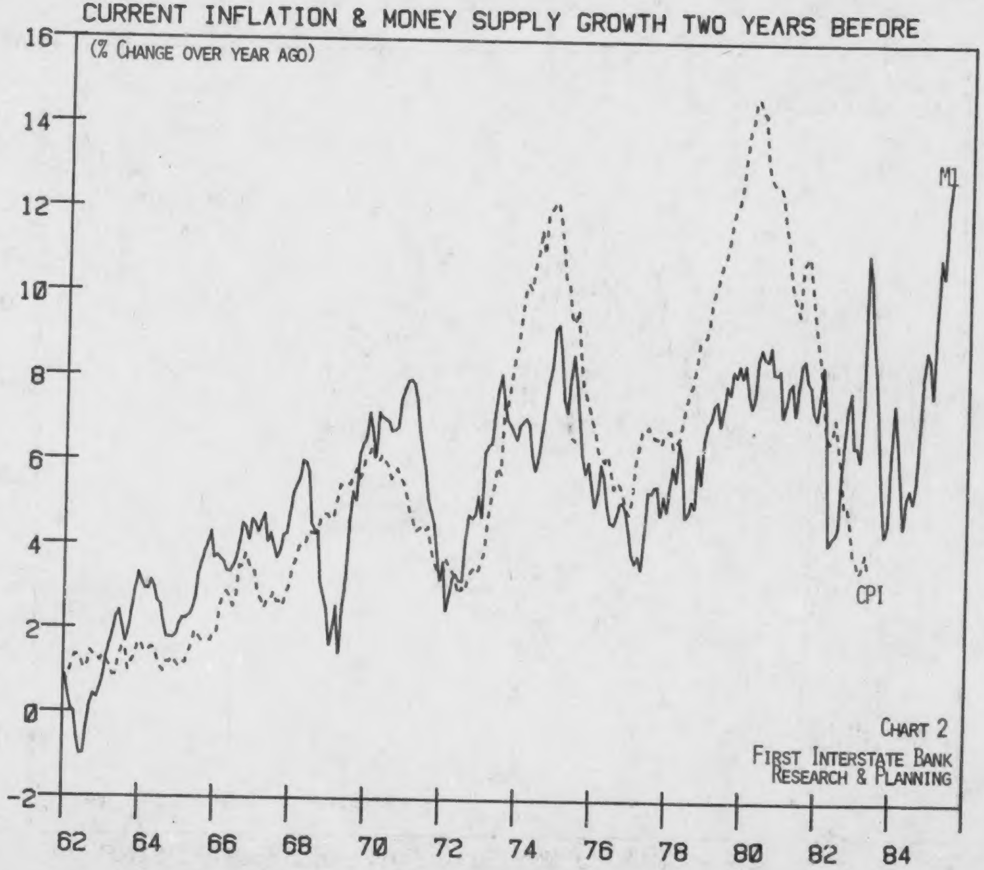


CHART 1

FIRST INTERSTATE BANK
RESEARCH & PLANNING



CURRENT INFLATION & MONEY SUPPLY GROWTH TWO YEARS BEFORE

CHART 2

FIRST INTERSTATE BANK
RESEARCH & PLANNING

Senator GORTON. Thank you both very much for providing enlightening statements as well as for your patience during the course of the day.

Professor Blinder, you put your view in a very cogent and a very witty fashion. You did say, however, a quarter of the way into your statement that you weren't really quite sure about the degree to which you disagree with Chairman Volcker, the statements which he made here today and in the House yesterday.

Are you more sure about the degree of disagreement you had with Dr. Feldstein?

Professor BLINDER. No, but I think I am with Secretary Sprinkel.

Senator GORTON. I think I am as well. That is why I asked the question in the other fashion.

Let me ask you the question which I asked of Dr. Feldstein, based on one portion of his testimony.

Do you differ from him profoundly enough to disagree with his statement, his absence of belief in the ability to trade inflation for sustained higher real growth? Do you believe that we could create over an extended period of time higher real growth by paying the penalty of inflation of 7- to 10-percent rate?

Professor BLINDER. As long as you put in the words "sustained" and "over a long period of time," I agree with him 100 percent. The evidence is very clear and the economic theory, for a change, goes along perfectly with the evidence in that issue.

### POTENTIAL FOR SHORT-RUN TRADEOFFS

Where I would disagree with Mr. Feldstein—and very vehemently, in fact—is over the short-run tradeoffs. I listened to what he was saying. I thought he grossly underestimated the potential for making such a tradeoff. Whether or not that is a good idea or not is another question entirely.

Regarding the potential for making such a tradeoff in the short run, I think the evidence is overwhelmingly pointing to a very strong tradeoff in the short run. The issue of disagreement—were he and I at the same table we could iron this out very quickly, I think—is a question of emphasis, like whether the glass is half full or half empty. I don't think there would be a large disagreement if we could thrash it out together with numbers.

I would like to just cite as a piece of evidence that the slowdown in nominal GNP growth or money growth or rising interest rates in 1981 and 1982 had a very profound effect on the growth of the real economy. It wasn't an accident.

There is no inherent reason why this process is not reversible. By juicing up the economy enough by easing money, we could have a boom of a magnitude comparable to the bust we had in 1981–82. That may be a bad idea for a number of reasons, but I took the question you asked me as simply a question of whether there is such a tradeoff in the short run.

Senator GORTON. Is it a good or bad idea?

Professor BLINDER. I think it is not such a bad idea, to tell you the truth. The question is always how much. Let me put some numbers to it. I think it wouldn't be a bad idea to have 6 percent real growth in the economy for a couple of years starting from today, and the projections are not for that kind of growth.

I think it wouldn't be a bad idea if we beat the unemployment rate down to 7 percent in less than 3 or 4 years, which is what the projections are.

If that is an answer to your question, I say, yes, it is a pretty good idea.

Senator GORTON. I suspect that everyone else who has been here today would say the same thing.

Professor BLINDER. Well, I don't think so in terms of whether it is a good or bad idea. I was hearing the opposite.

Senator GORTON. Would you, Dr. Meigs, disagree that if we could get unemployment down to 7 percent and have a couple of years of 6 percent real growth that that would be a bad idea?

Dr. MEIGS. Yes, because there is no longrun tradeoff. The problem is that if you have an acceleration of, say, money growth you get the first effects on real output and the effects on prices come with 2-year lags.

We have had many experiments in this country and other countries with such attempts to stimulate growth in the short run with an expansive monetary policy, and over the long period of the two decades I show on my charts. Secretary Sprinkel referred to them, Dr. Feldstein referred to them—in the United States and all the major industrial countries of the world. What we ended up with after two decades of experimenting was higher average levels of unemployment, higher inflation, and lower growth.

In the late 1970's, many countries, even before the United States, decided that that was not a very useful policy track.

Senator GORTON. Again, I am going to sharpen the differences a little bit more.

I didn't take Dr. Feldstein to say that he thought that would be a bad idea. I got the thrust of his testimony to be that we couldn't do it, that the positive impact of that kind of monetary policy would be much briefer than a couple of years before it resulted in inflation and stagnation.

Dr. MEIGS. It depends again on how rapidly we try to do it. As I say, we have tried it. You can certainly stimulate growth of real activity for a couple of years. I believe that you would have more inflation in the third year.

What I did warn against is that sudden changes in either direction do have sharp effects on output. Just as it can be potentially dangerous to overstimulate, too sharp a deceleration puts us into another recession. We have done that several times, twice in the last 5 years.

So that is why I would recommend being cautious on the deceleration just to avoid that. It is hard to avoid. Not many countries have succeeded in doing that. If it were done cautiously though, we might at the price of a little higher inflation 2 or 3 years down the road that we would otherwise have.

Senator GORTON. Professor Blinder's written testimony, which he didn't finish, ends with the statement that it is better to eschew intermediate targets and focus instead on things that really matter, like interest rates, investments, inflation, and real GNP.

I expect there probably would be very strong agreement on that proposition.

Professor Blinder, let me ask you this.

Every other witness who has testified today, while they might well agree with that as a proper goal, would, I suspect, say that the restrictions which you give us would not in fact have that effect.

Isn't the very fact that people in a position such as they hold—the Chairman of the Federal Reserve Board, the President's Economic Advisor, for that matter Dr. Meigs here who reflects, I suspect, the very strongly held views of the private sector—isn't the very fact that they believe that way something which would make their beliefs come true if, in fact, we should have a much more expansionary monetary policy?

Haven't we just seen in the last few months every slight indication that the monetary supply was expanding too fast, accompanied by increased interest rates rather than decreased interest rates and a fear of a return to inflation?

Professor **Blinder**. I don't think that is true. The Federal Reserve, in something around mid-1982, decided that they had overstayed monetary tightness and decided they should abandon monetarism, at least temporarily, and ease up on bank reserves and let the banking system expand much faster than it had been. Recovery started from that point, and interest rates started to go down.

We know from the minutes of the FOMC that were just recently revealed that they decided, I think it was May, that they should tighten monetary policy a notch because they are worried about these high monetary growth rates. Since then interest rates have been going up.

### REAL AND NOMINAL INTEREST RATES

So I don't think it is true that interest rates will move in the opposite way from what I have been saying. The important distinctions here are between short-run and long-term effects and between real and nominal interest rates. When you accelerate monetary growth—if we can impute any meaning to that statement, let's say you raise the rate of growth for banking services—that forces interest rates down. If the accelerated rate of increase of bank reserves is maintained, sooner or later there would be more inflation on that account. While interest rates may well still be lower, nominal interest rates are probably going to be higher.

This is the distinction that is too infrequently made in asserting that higher money growth always leads to higher interest rates. The interest rates that are being talked about are nominal interest rates. And it is true that after a while—and it may not be a very long while—higher money growth results in higher nominal interest rates. But it is presumably the real interest rates that are relevant to savings and investment decisions.

Senator **Gorton**. I want to followup on that question, but first I want Dr. Meigs to followup on what Professor Blinder just said.

Dr. **Meigs**. People in the financial markets learned some very hard lessons in the 1960's. As late as 1965 people did not pay much attention to anticipated inflation and its effects on interest rates. There is nothing like losing money in large quantities to sharpen one's perception, and that happened as the inflation rate rose, interest rates rose. People who had bought bonds in great confidence around 1965 lost plenty.

So now people in financial markets don't merely look at past prices to form inflation expectations; they look at what governments do. They look at the budget. They look at the trend of government spending. They look at the monetary policies of the United States and other countries.

And they react very sensitively. Sometimes they overreact. If people in the financial markets believe that the Federal Reserve or the Bank of England or the Bank of France or any other central bank is beginning to accelerate growth of the monetary aggregates, you can believe interest rates will begin to rise and without much delay. That is just a fact of life today. It is one of the things that does put more discipline on central banks than used to be the case.

Senator GORTON. I think this is appropriate followup. In a television interview last week, Henry Kaufman said that the link between nominal interest rates and expected inflation was not as good as it used to be, and that we could infer expected inflation by simply subtracting, say, 3 percent from nominal interest rates.

Obviously, I can't ask you to explain Mr. Kaufman's comments, but I am puzzled by the suggestion, and I would like you to address it. Do you think of nominal interest rates as being the sum of the real rate in the 3-percent range and current expectation in inflation rate, or is there another intervening factor which must be used to explain it?

Dr. MEIGS. One of the big issues is whether there is a constant real rate of interest. I think most people no longer believe that.

Secretary Sprinkel talked about this. He said in a year people looking back would say today's inflation rate, today's nominal rate, indicates a real rate of interest of, let's say, 6 or 7 percent when they used to think it would be only 2.

What is relevant there is not the current inflation rate but how much people expect there will be in the future.

Now what happened is last time we had a fall in the inflation rate many people were disappointed that interest rates did not come down as much as the inflation rate came down. But if you look at the history of interest rates, this is not at all uncommon. We have had many periods with similar lags.

A second point, a lot depends on the credibility of monetary policy and fiscal policy. A lot of people have seen inflation brought down dramatically. Between 1974 and 1976 it came down in a very similar way to this, but within 3 years the inflation rate was doubled or tripled.

So, in financial markets, people are rather cautious and do not really believe that the Federal Reserve or the Government will persist on a course of subduing inflation long enough to make it last.

Then another point, there has been so much instability.

All those factors tend to explain to me why real interest rates are higher than some people think they should be, but real interest rates are not a very easy thing to manage. One thing that would bring them down over a long period of time would be for the fiscal/monetary authorities to follow, very stable policies, with very few big changes, and bring the inflation rate down to zero, which I think would mean a high rate of growth in real output.

Senator **Gorton**. Professor Blinder.

Professor **Blinder**. If I understand what Mr. Kaufman was saying, I think it is correct. The nominal interest rate is the sum of the real interest rate plus the expected, looking out to the future, rate of inflation.

There was a period of time from, oh, say 1953 to about 1971, give or take, when the real interest rate in this country, however measured, was quite stable. It fluctuated a little bit, but didn't have major movements.

Since the mid-1970's that hasn't been true, and real interest rates have moved about a great deal. So while it is still true that the nominal interest rate is the sum of the real interest rate plus the expected inflation, it is not true that the nominal interest rate is the sum of an unchanging real interest rate plus the expected inflation.

If we go back a few months, it wasn't uncommon for short-term interest rates, like T-bill rates, to move by a 100- or 200-basis points within a couple of weeks. Those things were happening not too long ago.

I don't think anybody could believe that the expected 3- or 6-month inflation rate had moved that much within a couple of weeks. The only explanation for that is a change, a very large change, in real interest rates.

Senator **Gorton**. Do you agree with Dr. Meigs that a proper goal is a zero inflation rate?

Professor **Blinder**. No. I think the thrust of my answers to other questions you have asked about the longrun tradeoff is that there isn't much relationship between the longrun inflation rate and the real growth rate.

So we might have 3½ percent steady real growth rate in this country and zero percent inflation or 5 percent or 10 percent or even 25 percent.

Brazil was mentioned earlier. Brazil has enjoyed 6 to 8 percent real growth continuously though their inflation rate gyrated from 100 down to 15 back to 120; 6 to 8 percent real growth. You can have these kinds of real growth no matter what the inflation rate is.

The critical question—and the reason I say very strongly "no" to your question—is: How do you get from here to there? We know how we got from a 10-percent rate of inflation down to a 4-percent rate of inflation, and it hurt a lot.

If you want to get down from a 4-percent to zero, it is going to hurt a lot again, and I don't think it is worth it.

Senator **Gorton**. Dr. Meigs.

Dr. **Meigs**. It is true that we don't know very much about what determines longrun real growth rates or the connection between them and inflation.

My argument on the superiority of zero inflation is simply that if you try to target anything else the monetary authorities will never hit it. If you say, we should tolerate a 5-percent inflation rate, it wouldn't be long before it's 7 or 8. And one thing that has been observed is that the higher inflation rates become the more unstable they become. That does distort a lot of managerial decisions, investment decisions, and I believe gives us a lower real output than we would have otherwise. So you could hold the monetary authorities responsible for aiming to get a zero inflation rate over a long period of time.

One of the advantages of that would be that we would get a better allocation of capital.

It doesn't make a whole lot of difference except I don't think Americans would like to live like Brazilians, even with a higher real growth rate.

Senator **Gorton**. Senator Riegle, I have gone over my time, but I have finished with the questions I intended to ask, and I must be someplace else. So I will simply turn the gavel over to you, and you can ask questions as long as you wish.

### OUR PRESENT POLICY MIX LOOKS DANGEROUS

Senator **Riegle** [presiding]. I do want to make two points and then raise a question with you. I think your assertion, Dr. Blinder, that the Fed changed their direction dramatically last year is obvious on its face, and if anybody needs proof of that, just the fact that they have operated so long above their own targets—I mean they set the targets—has set them to thinking that that is where they wanted it, and then when they consistently ran substantially above their targets—what logical conclusion can anybody draw when their targets are off and so in fact they set new targets, though they didn't state that? They just decided they had to shoot higher, and in fact have done so. And now they are folding a 14-percent increase into the base so that in fact with the new targets they are talking about a 11½-percent increase off the old base. It certainly gets lost in the numbers here and nobody will pick up on it.

Everybody worries about next year's deficits, and in this year's deficit at the end of the year we end up with a lot of money in supplementals, and it goes way out of sight.

But everybody stopped looking at 1983 because 1984 is what is going on.

It seems to me in some respects the Fed is doing the same thing.

To go to the question of monetary policy, it seems to me that monetary policy is a very, very important instrument when it comes to solving the inflation problem. You can do something with inflation, depending on what makes up that inflation, where you are.

The notion that you can hammer it down to zero with monetary policy I think is a very dangerous policy, with no disrespect to your view to the contrary.

I think if you look at all the structural weaknesses we have now there is a lot of it, and we haven't solved our problems at all. But if we were to decide what we want to do was to face more and really bring out what is left of inflation, I think it wouldn't take long before we would have some serious international defaults. We have a problem right now in getting the House of Representatives to vote for the IMF authorizations, which should they not be provided, you would have the banks backing away themselves.

It wouldn't take long. I don't know what the impact would be on confidence in the national markets if a major country defaulted, in addition to those that have already in a sense defaulted, and so forth.

I think if you talk in terms of using monetary policy in terms of getting inflation down to zero that would be a highly dangerous strategy.

What I would really like to pose to you is the question that I have been trying to pose really in a way to Chairman Volcker and to Chairman Feldstein and others, and that is where we are now in terms of the overall policy mix and is that policy mix sufficient as it is now, absent any major further adjustments, to sort of take us on through to the kind of future we would like to see—declining unemployment, renewed growth, low inflation, and so forth.

When I pose that question to myself I think we are in a very dangerous condition. I don't know that that's exactly a fool's paradise, but I think it is close to that, if we think that if we make no further change that we would get all the nice things and not have the very miserable day of reckoning somewhere up the road, whether it comes in 6 months, 9 months. I can see it coming.

But I see it coming, because it seems to me we have got some fundamental contradictions in the overall macroeconomic policy mix, if you will, that there is irreconcilable contradictions. Obviously there are enormous deficits and the fiscal problem is real and we are not doing anything about it. The President has backed away from it and the Congress seems to be backing away from it.

I was saying earlier we're in a 1½-year window now headed for the Presidential election, and that tends to make hard decisions all the harder. I don't think the Congress is going to deal with the fiscal problem in a meaningful way and the President already has slipped out the side door on that issue several weeks ago.

So you've got the deficits, you've got the trade deficits. We've got a $70 billion trade deficit. It's rising. I have every reason to think it is going to continue to rise for reasons of the fact that we have an exchange rate problem. Also foreign countries are in trouble. They can't be importing our goods; they've got to be exporting more of their goods as part of the way to get the extra money.

So we're in a very, very difficult situation there. If the merchandise trade deficit can go from $36 billion to $70 billion in 12 months, what is to say it can't go to $110 billion over the next 12 months? What does that mean? It worries me.

The savings rate is not terrific. We are not beginning to save at the level we need to save to finance everything we want. Caspar Weinberger can't find anyplace to save any money in the defense budget. Other things are hard in terms of any further reductions in entitlement costs and other domestic spending.

Unemployment is still very high. We are starting out here at a point where each time the plateau level seems to crank up 2 or 3 percentage points, but we're now over the 10-percent level.

I mentioned the foreign debts. I think the international situation is far more perilous than anybody would care to talk about. Everybody kind of tiptoes around that problem because if you shatter confidence you make your problems worse. So everybody basically whistles by the graveyard on the international debt problem.

Behind that comes the wage-and-price problems. Paul Volcker is sensitive to that. He's starting to talk a little bit about that.

So as a matter of fact you're going to get a certain level of cost-price push, wage push, and inflation coming along here under the best of circumstance, and perhaps a lot of it under the worst of circumstances. We haven't dealt with any of that. It's very hard to deal with. Who wants price-and-wage controls? At least not people in political positions. We don't seem to be able to devise an incomes policy.

So those issues sort of tend to get lost in the shuffle. When we may be running along at 70 or 80 percent of capacity and you've got 10 million unemployed they don't seem like big problems. But they are out there; they are unsolved; and they are going to come back and haunt here, I think, quite soon.

### FED ADJUSTMENTS WILL SLOW RECOVERY

So I add all that up and I say to myself, all right, how do we solve this. Well, the way we solved it the last time is the Federal Reserve basically put their foot on the brakes and we had a very tight monetary policy. We shut the whole works down to a very substantial extent internationally.

Now the Fed is back in the same box, because now they feel no fiscal restraint. None of these other things are being dealt with. So what's happening? The only policy tool that seems to be one that anybody can get ahold of is Fed policy, so now they are trying to put their foot on the brake, and God knows, most people are saying don't put your foot down hard, just hit it a couple of times.

If they start to put their foot on the brakes everybody else around says I'm glad you're doing that because now we don't have to do the part we thought we could do. Let the Fed get it done. Then the problem is the Fed is left with a situation where if they're going to try to deal with the contradictions it is almost inevitable that they are going to have to tighten down further and further and further because this credit crunch has come. We're going to have to pay for these deficits. The savings rate isn't there, and we can't just count on money flowing in from abroad especially for long-term investment for things that are not short term in nature, whether it's housing, plant reconstruction, or what have you.

So we are right back in the situation where interest rates are going to have to go back up, and if they go back up they are going to shut down the economy.

We don't have a workable policy mix at the moment.

I would like to say one other thing and I would like your reaction to it.

Look at the financial markets. It seems to me what the financial markets are doing in a general sense is tracking exactly what has happened here. The stock market went into the tank when the economy hit rock bottom. The economy starts coming back, interest rates start coming down, people start getting out of bonds and into stocks, you get a lot of institutional money, profits start to reappear in terms of corporate earnings, the stock market is oversold, it has to rise and starts to rise, and everybody sees that as the place to go and invest a lot of money.

So you get an upward rise in the stock market. It's almost like physics. You can almost predict it is going to happen. That is not to say that it is going to keep going forever or that these contradictions aren't going to catch up with us here sometime soon.

I'm very much concerned that they are. And I'm very much concerned that if we don't face reality pretty quickly here and fight awfully hard to make the adjustments we're going to find ourselves going right back down the downside of this. It's just a question of when it happens.

I would like your reactions to that set of concerns I'm expressing and whether or not you agree or disagree.

Professor **Blinder**. I heard what Dr. Feldstein said in answer to that question before. In large measure I agree with that. As he put it, the most likely scenario under no change in fiscal policy is that we will continue to manage some kind of a recovery, but a very lopsided recovery. And it will be lopsided in a very predictable way: The housing industry will be left behind, the automobile industry will be left behind, and in general the export competing industries will be left behind because of the problems caused by the exchange rate.

As you say, if the Government is doing all this borrowing and private individuals are not doing all the savings, where do we get the money from? We borrow it abroad. We have to attract it by high interest rates. That's all very nice, since we don't have to save it ourselves. All of us like to live on someone else's credit. The way we pay the piper for this is by the rise in exchange rates, which is simply annihilating the export industries in the United States.

That's very problematic. When you think of what those export industries are, and where are they located, much of what we think of as the industrial base of the United State is either an export industry or should be an export industry, or an export competing industry—steel, automobiles, chemicals.

So that's not a very happy prospect.

You could conceive of an economy that is booming along with consumer goods and toys and the steel industry and auto industry are going to hell and the export industry shuts down. The GNP may keep going up if the toy industry is growing fast enough, but I don't think that is the sort of thing that you would like to see. It's certainly not the sort of thing that I would like to see.

The other thing to be said about that—he also said this, and I would like to emphasize it more—is that this is only the best guess as to what would happen under constant budget policies. But there is a risk that things could be a whole lot worse.

The risk comes from two places, one of which Feldstein mentioned, the other of which he didn't, but I mentioned in my testimony. The first is that we don't really have experience with a protracted recovery with these kind of real interest rates. So we are guessing.

One aspect of your statement that I disagree with is when you said it's like physics. It's not like physics. We are not quite sure how the economy will really react to this particular thing we're putting in, the very high real interest rates.

Senator **Riegle**. What I meant to have reference to was the fact that under certain conditions you'd have people bailing out of bonds, getting into stocks, and I think there is a certain tip point that is akin to physics when you get sort of a basic turnaround on interest rates.

Professor **Blinder**. There is some reason to worry that maybe we can't muddle through with these high interest rates. I think the chances of that are well less than 50 percent. We probably can muddle through in a lopsided way. But it's a worry.

Senator **Riegle**. You say the chances that we can are less than 50 percent?

Professor **Blinder**. The chances are that we cannot. The chances are well over 50 percent that we could have a slow or moderate lasting recovery in a lopsided way even with these high real interest rates.

Senator **Riegle**. Could you tell me what that eventually leads to? Could we do that for 5 years, 10 years, 15 years?

Professor **Blinder**. To recover back to something like full employment, if we grow at something like 4 or 5 percent a year, it is going to take something in the 5- to 7-year range, at which point you have something that looks like a fully employed economy that has a smaller housing industry, a smaller auto industry, and lots of other smaller industries and bigger industries in certain other things, especially in consumer goods, maybe some particular machine tools, especially short-life capital equipment that is very much favored by the ACRS. Those kinds of things would be expected to grow relative to the rest of the economy.

The second thing that I emphasize in the testimony is that the Fed might make a mistake while just muddling through. The process is a subtle one. We don't know what velocity is going to do for the next 2 years, just as we didn't know 2 years ago what it was going to do for the following 2 years. And they could make a gross error as they did in 1981 and 1982, and push us back into another recession. And that is not a negligible possibility.

Senator **Riegle**. Where would you put that probability at?

Professor **Blinder**. A third to a quarter. It's a big guess. If I knew what was going through Chairman Volcker's mind, I could make a better guess. But I don't.

### FED SHOULD KEEP INFLATION DOWN; BE CAUTIOUS

Dr. **Meigs**. On the first point, I certainly would not advocate any forceful attempt to have inflation down to zero in a couple of years. It looks to me more like a 5- to 10-year project if we're lucky.

I think what we need is more longrun monetary policy, and then the same thing in fiscal policy.

If you change the numbers of the thermometer you don't change the temperature on the room. The problem is more persistent than that, and I would say just looking at fiscal policy over the long period in the United States it has been consistently biased against saving and investing. Shares of income going to Government have been rising for years, and it is a process that is accelerated by inflation where you have bracket creep in the income tax.

So these should make interest rates higher as opposed to pulling capital from abroad and capitalizing the economy in the form of goods that hurts some of our producers.

These are all very difficult problems.

But the Federal Reserve cannot offset these effects by creating money to reduce interest rates, because the financial markets simply will not allow the Federal Reserve to push interest rates down for more than a few days or for a few minutes.

We have had a history of great instability in monetary policy. I said earlier that this disability in monetary policy has helped damage fiscal policy. The answer to me is you have to constantly look at the economy becoming as stable as possible in both fiscal and monetary policy. Avoid big changes and work very carefully in the long term, because in the budget you have a very difficult and vital problem allocating the Nation's resources—how much defense do we need, how much of this or that. These functions cannot be handled very well if you are preoccupied each budget year with the fact that we are in a recession this year and next year in a boom and then in a recession.

I say, tell the Fed to get their act together, be very cautious, get inflation down, and stop trying to do too much. That will help you in your budgeting problem, which is not an easy problem.

Sure, we have lots of problems, but we're still a lot better off than many countries in the world. I'm not that discouraged about the future.

Senator **Riegle**. Let me give you one more thought to react to. I'm an optimist. I've been here 17 years in the Congress and have had some chance to see it on this end. I represent Michigan. We're in our 38th consecutive month with unemployment above 10 percent and our 15th above double digits. So I've had a chance to sort of look through the window from that vantage point. But I also had a chance last year to serve as the ranking Democrat on this committee while we were trying to keep the S&L industry from sinking beneath the wave, and managed to do that through legislative action, including some devices, such as accounting devices among other things, to basically sort of pass that problem so we could get on into, hopefully, recovery, which seems to be underway now.

The thing that concerns me here is if deficits are going to continue to run over $200 billion, and it is my best surmise that they will—I think if Senator Gorton were here he would agree with that, although I don't know. He has to speak for himself. A large part of that $200 billion deficit is not cyclical deficit that is going to get better.

We have made some fundamental changes that give us a very adverse and, if you will, lopsided fiscal policy. It is coming in the midst of an enormous structural change in the world economy where things are just different. I mean the relationship with ourselves to Japan, not just in all those things that are obvious, but in other things. It has changed fundamentally. It is going to take an awful lot of effort to get ourselves repositioned in terms of that puzzle.

The thing that I am concerned about here is if the deficits are not going to be below $200 billion and we are not going to be able to jack up the savings rate substantially—I mean we are headed into a credit crunch here that is inescapable, and especially in light of the fact that everybody is saying that the Fed ought to accommodate it when it comes, but the fact of the matter is it is inescapable, it's going to come. What's going to prevent it from coming?

It seems to me that if that is the case we had better all admit it, we'd better admit—if that is what's coming, if those are sort of basic components of the overall policy mix, that we are headed for a day of reckoning here that is going to be very severe.

If you don't believe that, if the deficits of that size don't matter when you put it together with the world trade picture and the interest rate picture and so forth, if you look at the savings rate picture and you say it doesn't matter, then that is something else again, and I want to hear that if that is what you believe.

It seems to me what is happening here is almost an unconscious tendency to finesse that question, because if you have to face it square on then you have to really make a pretty strong statement about an awful lot of things having to happen some time soon. People basically don't like to do that.

### MUST HAVE SOME INFLATION TO CUT INTEREST RATES

Can we take deficits above $200 billion in the next 5 years and just sort of still have it all work out?

Dr. **Meigs**. I would prefer that we not do that.

Senator **Riegle**. I know you prefer it, but the question is will it undo us. That is the issue.

Dr. **Meigs**. No.

Senator **Riegle**. It will not drive interest rates up in your opinion?

Dr. **Meigs**. It will make the economy perform not as well as it would without this problem. As Mr. Blinder said, there is a change in the character of the economy. It has had a lot more economic activity run by Government and less by the private sector. I think over time that means a lower growth rate. But other countries have tolerated such things. I don't like that, because I would prefer a budget policy where you really have control over expenditures and consciously allocate things and not have the budget grow by accidental accretion or inflation.

But that is a longrun problem. I have no easy answer to that.

Senator **Riegle**. Do you want to react to that?

Professor **Blinder**. I would say that the Fed can prevent this inevitable, or rather noninevitable, credit crunch, but at the price of declaring a truce in the war against inflation. The word that is often used is reinflate the economy rather than disinflate the economy. And that is the way the Fed would do it, by monetizing a goodly share—not a goodly share; we're only talking about a few percent anyway. The Fed typically monetizes 4, 5, or 6 percent of the deficit. I don't know how much we're talking about. Maybe we're talking about monetizing 7, 8, or 9 percent of the deficit. I'm not sure. But they can prevent the high interest rate consequences that we talked about, but at the cost of injecting more liquidity into the economy and losing ground in the war on inflation. And that's the trade off that we have.

The other thing I want to stress about that is that there is no big rush. We are not at this point now. The credit demands of the private economy are still moderate; the economy is still quite depressed even though we've had two quarters of positive growth. And there isn't any problem selling the Government's bonds right now. So it is not something that requires panicy action. But if things continue as they are, we will likely progress the way you've described. And if the Fed is going to stop it, it is going to have to inject more money and credit or something like that.

Senator RIEGLE. You're going to have a very hard time doing that because people like Mr. Meigs are going to scream very loud when that happens. The Fed will start the tightening process because that's the only show in town, and the more they do the less is done on the other parts of the policy that could also accomplish the same end without requiring so much tightening, and then we are going to start down the slope again, and at some point either political pressure or just the sheer requirements of the economy are going to cause them to do exactly what they did last year, that is, they are going to reverse gears. They absolutely reversed gears and they started pumping money out like mad. But it depends on when you start it. If you want to start from the time they started pumping the money back in, then you could say, well, the gain that we have made is *x* billions in inflation savings.

You can also do a calculation of *x* hundreds of billions in lost production and the other damages that's been done in the meantime. Recessions are enormously expensive, and the country loses years in terms of things it doesn't do because it's got big chunks of itself sitting idle, including the pileup of Federal deficits. We are carrying these $200 billion deficits in the national debt and paying interest, and that can be rolled over forever more.

Dr. MEIGS. I agree with you on that. But there is one big problem with what you said about the Fed suddenly increasing its speed. We are always reacting to the Federal Reserves' most recent mistake. If you look at their behavior over two decades you would believe that the Federal Reserve has only two speeds—too fast or too slow. They never hit it in the middle. What I would urge you and your committee to urge them to do is for once hit to the targets that they announced in advance and to do it cautiously and don't be constantly overshooting and undershooting. They do damage in both directions everytime they do that.

### ADJUSTMENTS IN POLICY MUST BE MADE NOW

Senator RIEGLE. I would make one final observation to you before we wrap it up here, and that is that I think we are at a certain critical moment right now. We need some major additional policy adjustments on the fiscal side and some other areas as well, and we are in effect trying to do it on the international debt side.

I think we also need a trade policy that is more thoughtful, more up to date than we presently have, because I think it is hurting us as well.

But if the President of the United States personally as the top elected officer in the country and his administration is not actively involved and sees this as a major item, sees this as a top priority, and this is not taking a major part of every day to work this out with Members of the Congress in both parties to wind the policy mix up, to really deal with fiscal policy, make the trade-offs—maybe that means more cuts in defense spending than he wants, more restraint in domestic spending than somebody else here in the Congress might want. But in the end you come up with a deficit that is not $210 billion, but it's $170 or $180 billion, and you really get on down the sloping track and do some of these other things, and you try to start on some kind of an incomes policy if it's nothing more than jawboning—it could be a friendly jawboning. We went through jawboning in the extreme in Chrysler. We mandated it by law. It worked quite well, as a matter of fact. Everybody has come out ahead as a result of it.

It seems to me that that is what we ought to be doing right now. But that is not what we are doing. That isn't the national debate; that is not where the focus is; that's not where the work is going.

Where I think you can be especially helpful is if in thinking about this, if it was the judgment of the top professional economic strategists and thinkers like yourselves who are out either in the university world or private sector—to the extent that needs to happen, if you don't say so and if you don't ask for it and others like you are not part of the consensus that are sort of ringing the bell and saying, look, we really need some major adjustments here, we need more concentration on getting this done, and there is a moment here in time where perhaps now we can take a look at things, it becomes less and less likely to happen, and we're going to go skating right down through the next year and half. You just watch and see if that isn't the case.

Barring some extraordinary effort to come in and start to make further adjustment in this overall policy mix—if you want to come back here in the spring of 1985, regardless of who runs and wins the Presidency, I think you will find that barring some kind of an additional major focusing effort of the kind I described that this thing is not going to work properly because it is not engineered at the moment to work properly. We still have the contradiction between the fiscal and monetary policy, and that desperately needs to be resolved and is not in the process of being resolved.

In any event, it is good to have you here. I appreciate what you said. I have read both your statements and I think they are helpful to us and made a contribution to the record.

Thank you very much.

[Whereupon, at 5:27 p.m., the hearing was adjourned.]

# MONETARY POLICY RESOLUTION

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THURSDAY, JULY 28, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON ECONOMIC POLICY,
*Washington, D.C.*

The subcommittee met at 2 p.m., in room SD-538, of the Dirksen Senate Office Building, Senator Slade Gorton (chairman of the subcommittee) presiding.

Present: Senators Gorton, Garn, and Heinz.

## OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. Good afternoon and welcome once again to this hearing room, Chairman Volcker. You have spent a great deal of time here. Thanks for returning so soon after your appearance last week.

The committee has had an opportunity to discuss your monetary policy report at some length and my opening remarks will be brief.

We are interested in your views on a topic closely related to the monetary policy report you provided last week. As you know, section 6 of this year's first concurrent budget resolution requests the Banking Committees report to their respective Houses a resolution expressing the sense of Congress as to appropriate monetary policy.

My own interest in this issue arises out of my interest in the Federal budget and its numerous effects on the economy. Most of my colleagues on the Banking Committee have, of course, longstanding interest in monetary policy generally. The budget resolution provision reflects I think two concerns. First, there is the obvious issue of monetary policy itself and the problems that can confront it given the Federal budget and the current state of the economy.

Second, there is the underlying issue of congressional oversight of monetary policy. The nature of the Federal Reserve System which is described as independent within Government is I think a uniquely American solution to the conflict between the need to insulate to some degree the central bank from short-term political pressures and the need to insure that it is ultimately responsive to the will of the people.

There is continuing tension in the relationship with the Federal Reserve Board to the Congress and the Executive, but I think it is for the most part a creative tension. Clearly, the nature of the institution puts a premium on the integrity of the men and women who run it. We have been fortunate in having a succession of highly respected Governors of which you are the most recent.

I believe the system has worked well to date but it is always important for Congress to exercise vigorously its oversight responsibilities.

With that introduction, I look forward to hearing your testimony after a statement by the chairman of the full committee.

Senator **Garn**. I have no statement. The chairman has had to listen to me so much lately that I came just to listen to him today.

Senator **Gorton**. Senator Moynihan did, however, come to introduce his fellow New Yorker and although we have a vote beginning I don't want to have him come back, and we will certainly be delighted to hear what our good Senator has to say.

## STATEMENT OF DANIEL PATRICK MOYNIHAN, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator **Moynihan**. Well, Mr. Chairman, I thank you and it's an honor indeed to welcome and introduce to this committee a fellow New Yorker.

I have a statement, Mr. Chairman, that I'd ask be placed in the record as if read.

Senator **Gorton**. Without objection.

Senator **Moynihan**. I would offer only the briefest observations about the sequence of legislative concerns and acts that have brought us here today. We are participants in what could well be a major event in American economic history, the attempt to understand and, if need be, reform the institutional arrangements by which we set economic policy in the U.S. Government.

As the chairman would know better than I, our Nation's institutional arrangement for economic policymaking are singular. Ours is the only democratic nation of any economic size in which fiscal policy and monetary policy, the two essential parts of macroeconomic policy, are set by different institutions. In consequence, we have experienced difficulties in coordinating these policies in a single program.

If you want to take a historical view, you could say that of all the great issues that troubled 19th century America, the one never fully resolved focused on who properly has the power to create money. This issue was present at the creation—when Alexander Hamilton advised President Washington that it should be managed by a national bank, while Thomas Jefferson objected that the Constitution provided for no such arrangement, and Hamilton responded such was implied in the Constitution, and thus began the fundamental struggle between implied and strict constructionism.

We went from one national bank to a second, and back to none, from greenbacks to species, and a national banking system to help finance the Civil War. We closed the 19th century with Mr. Bryan going on about the cross of gold, and no one knowing quite what to do about bank panics or monetary expansion. After the devastating panic of 1907, a commission was established under Senators Aldrich and Vreeland, which led to the creation of the Federal Reserve System. An arrangement which continues to this day, but one with vastly larger powers and responsibilities, which have never been better performed than by Chairman Volcker.

Even so, the Government's spending and taxing responsibilities—the fiscal coordinating mechanisms have evolved, and their absence has led us into great difficulties.

It is my view, and the view of many others, that the great recession that we have just been through came about, in very considerable measure, through a clash between uncoordinated monetary and fiscal policies in 1981.

The executive branch commenced a vastly expansionary fiscal policy—large reductions in taxes, with continued growth in spending, especially defense. This necessarily brought on great deficits, deficits that have no precedent in our entire history. Whatever they were called, they were vastly expansionary.

The Federal Reserve, whether in response—that is something only the Chairman can speak to—or whether simply lacking a coordinating assumption, proceeded with the tightest monetary policy in more than a generation.

The specifics are that in 1980, the central measure of the money supply—and $M_1$, I know the Chairman has many reservations about its definition—but in 1980 $M_1$ grew 7.3 percent; in 1981, on a thrift adjusted basis, it grew by 2.3 percent. This was the sharpest 1-year plunge in money growth rates in the postwar era and the tightest monetary policy since 1959.

In December of 1981, I suggested that a very expansionary fiscal policy and very tight money policy had produced a program at war with itself, and one that would bring on a deep recession. Which did indeed come about, with the highest unemployment rate since the depression of the 1930's, and the lowest rates of industrial capacity utilization. At the end of last year, the steel industry was operating at under 30-percent capacity. This program also produced the sharpest 1-year plunge in corporate profits in the postwar era, the worst budget and trade deficits we have ever known, the highest sustained real interest rates, I believe, in the economic history of the United States.

With that in mind, on March 31, 1982, in the Budget Committee, of which you, Senator Gorton, are a distinguished member, I introduced legislative language to better coordinate our fiscal policy, which is nominally set in the budget, with monetary policy. The specific language was of no great consequence. But the idea, I think, was. And in the last stages of the budget consideration, with the chairman of the Budget Committee, your friend and mine, Senator Domenici, I offered language which in effect acknowledged this grave matter. For the first time in congressional history, we spoke to the director of monetary policy. Last year's budget resolution directed the Federal Reserve to reevaluate its monetary targets in light of the fiscal policies in that resolution.

In this year's budget cycle, we in the Budget Committee became somewhat more ambitious, with rather more specific ideas as to what to do. Even as in the House very specific proposals on that matter were advanced. In discussions with the distinguished chairman, Senator Garn, and Senator Proxmire and others of this committee, we reached agreement that the budget resolution should propose that the committee take up this issue and report to the Congress on how monetary and fiscal policy should be better coordinated for the coming fiscal year and that is what has brought us here today. I think for me to add more would only be to tell you what you already know are my views.

I might just say in closing, however, that a number of us have introduced legislation to establish a National Commission on Monetary Policy, a body that would in effect be a successor to the Aldrich-Vreeland Commission, with 20 members appointed by the President from the executive branch, the Congress, and the Federal Reserve System. This Commission would investigate the entire matter of policy coordination in depth, and recommend reforms in our institutional arrangements to facilitate the degree of explicit coordination deemed most desirable and proper.

My only purpose in appearing here today, besides the honor of introducing Mr. Volcker, is to say that this question of institutional arrangements goes beyond this year's budget or next year's budget, this recovery or the next downturn. It has to do with how we manage our basic economic affairs, and whether arrangements which in some significant way can be said to be premodern, or which at least certainly predate the role of the United States in the world economy are still adequate. And whether better arrangements can be made, and better policies agreed to by our respective bodies.

With that Mr. Chairman, I thank you for your great courtesy.

Senator GORTON. We thank you for your fascinating ideas, Senator.

[Complete statement follows:]

### STATEMENT OF SENATOR DANIEL PATRICK MOYNIHAN

This is an occasion of some moment, one with considerable history. The Federal Reserve has always been accorded considerable independence. And such it should be. The Federal Reserve is an institution of Government, one of several crucial economic policy institutions. As such, all must work together. Such it must be, and such it usually has been.

In this regard, the Federal Reserve has long maintained an effective working relationship with the economic policymakers of the executive branch, especially with the Department of the Treasury. This is natural and necessary. The chief instrument of Federal Reserve monetary operations is the open market transaction—the sale and purchase of Treasury securities on the open market, to contract or expand the supply of bank reserves. And the Treasury is responsible for the issue and redemption of Treasury securities.

But the interrelationship between monetary policy and the other dimensions of Federal economic policy go beyond this matter. We have learned a hard lesson in the last 3 years, and that is that if fiscal and monetary policies are not properly coordinated, the Nation's economy will suffer.

Thus, in 1981, the economy found itself buffeted by, on the one hand, the most expansionary fiscal policy in our history—with projected and actual deficits far beyond those ever seen previously—and on the other hand, the most contractionary monetary policy in more than a generation. $M_1$ the central measure of the Nation's money supply, had grown at a 7.3 percent annual rate in 1980; the next year, in the face of the hemorraging deficit projections, $M_1$ growth (shift-adjusted) plummeted to 2.3 percent. This was the tightest money policy since 1959, and the sharpest 1-year plunge in money growth rates in the postwar era.

The results of this collision of fiscal and monetary policy—a "policy at war with itself," I called it in December 1981—were predictable. Interest rates rose to new highs, especially real interest rates, and economic growth halted.

What followed is well-known: the worst recession since the Great Depression. More than 12 million unemployed. The highest business bankruptcy rates since the 1930's. The largest budget and trade deficits in the nation's history. The lowest capacity utilization rates in the postwar era.

The clash of policy did not go unnoticed. In March 1982, with Senators Riegle and Sasser, I proposed a budget plan based on a new mix—real coordination—of fiscal and monetary policy. Both extremes would be moderated. Fiscal policy would become more restrained, as monetary policy eased. We called on the Federal Reserve to return to the monetary growth path suggested by the President, in his Program for Economic Recovery of February 18, 1981. Under this proposal, the growth rate of $M_1$ was to decline by about 0.6 percentage-points annually, from 1980 through 1986—instead of the 5 percentage-point drop from 1980 to 1981. We asked the Joint Economic Committee and Data Resources Inc., one of the nation's preeminent econometric forecasting firms, to simulate the results of our proposal to coordinate fiscal and monetary policies.

The results were startling. The recession would end by summer 1982, and vigorous sustained economic growth would be restored.

This plan was not adopted. But working with the distinguished chairman of the Budget Committee, we did manage to attach monetary policy language to the budget resolution in May 1982, language subsequently adopted by the House of Representatives and by the entire Congress in the conference report in June 1982.

Under this resolution, the Federal Reserve was directed to reevaluate its monetary growth targets, in light of the reductions in the deficit mandated by that budget resolution. May I tell you, this represented the first direct congressional expression of views on the conduct of monetary policy in the Nation's history. The working relationship between the Congress and the Federal Reserve would never be quite the same.

And the Federal Reserve listened, as it properly should. Within 1 month, the Reserve began to ease monetary policy dramatically. Within 6 months of this ease, the economy began to respond, to turn-around and begin to grow.

This recovery, however, began at a very tepid rate. The real growth rate for the first quarter was less than 3 percent—about 40 percent the rate for the first quarter of previous postwar recoveries. Unemployment was projected to remain in the region of 9 percent for 2 years, and corporate profits and personal income would grow at seriously subnormal rates.

This was not acceptable. Vigorous economic growth, and sustained economic growth, should be the central goal of national economic policy, and all the economic policy institutions of Government would have to work together to achieve it. Such, at least was my view.

On March 2, 1983, with Senator Hart, I introduced a resolution stating this goal and a means of achieving it. The economic recovery should be at least comparable to the recoveries from previous postwar recessions, and the Federal Reserve should do its part to ensure it. According to our resolution: "Resolved, it is the Sense of Congress that, in order to ensure healthy economic recovery, the Federal Reserve System shall manage monetary policy to accommodate the growth in the Nation's nominal gross national product required to achieve real economic growth comparable to the average rate for the first eight quarters of previous postwar recoveries."

Once again, we had not proposed such a policy shift without being quite certain as to the probable consequences. With the assistance of the Joint Economic Committee, we asked Data Resources Inc., to simulate the economic policies required to meet the goal of the resolution. That is, we asked DRI and the Joint Economic Committee if we could coordinate monetary policy with fiscal policy—given the dimensions of fiscal policy—to achieve 5.4 percent average annual real growth in 1983 and 1984, which would be comparable to the real growth rates for the first 2 years following previous postwar recessions.

DRI and the Joint Economic Committee told us that it would be done, and the results would be heartening. Unemployment would drop to 7.6 percent by 1985, instead of the then-current projections of 8.9 percent. The interest rate on Treasury bills would drop to 6.9 percent by 1985, instead of the then-current projections of 7.4 percent. The nation's GNP in 1985 would be some $203 billion larger than that projected by the administration. It could work.

The point of our resolution was not based on the specific numbers. The point was, and remains, simple: vigorous economic growth, consistent with reasonable price stability, must be considered the central goal of national economic policy, and the Federal Reserve must coordinate its policies with the fiscal policies of the Congress and the Executive Branch in order to help meet this goal.

Working with the distinguished chairman and ranking minority member of this committee, we fashioned compromise monetary policy language for the Budget Resolution. The key sections of this compromise language read: "As there is a need for coordination between fiscal and monetary policy; And, as there is a need for vigorous economic growth consistent with reasonable price stability; Now, therefore, the House Committee on Banking, Finance and Urban Affairs, and the Senate Committee on Banking, Housing, and Urban Affairs are requested to report to their respective bodies, no later than June 30, 1983, a resolution expressing the Sense of the Congress as to the coordination of the Federal Reserve's monetary policy with the fiscal policy reflected in this budget resolution."

This was truly historic. This represented the first congressional statement in our history that fiscal and monetary policy are not independent entities, but rather must be considered part of a larger whole. Monetary policy could no longer go off on a collision course with fiscal policy—something I am certain the Federal Reserve would never intentionally do. But inadvertant collisions of policy could be averted if conscious coordination were undertaken before the fact. This is the intention of the monetary policy language.

And in the current circumstances, this coordination must be achieved with one central goal in view: "vigorous economic growth consistent with reasonable price stability."

The version adopted by the entire Congress, in the conference report, retained all these provisions. Moreover, it went a bit further: it requested the Banking Committees to report, not only on how the Federal Reserve should coordinate its policies with fiscal policy to achieve the central goal, but further what information will be necessary to ensure policy coordination in the future, information regarding the assumptions and goals of the Federal Reserve System.

This is what brings us together today.

And may I say that the Federal Reserve System under the leadership of Chairman Volcker, has moved decisively to work together with Congress and the Executive to achieve vigorous economic growth. Chairman Volcker announced last week that the target growth range for $M_1$, the central measure of the Nation's money supply, would be changed in two ways. First, the formal target was raised from 4 to 8 percent, to 5 to 9 percent. At the same time, Chairman Volcker announced that the new growth targets would be measured, on a prorated basis, from a base of $M_1$ in the second quarter of this year, instead of the fourth quarter of last year.

This is what this means. The average for $M_1$ for the second quarter of this year was $505.3 billion. Assuming $M_1$ grows at an annual rate of 5 to 9 percent over the second half, $M_1$ should fall between $517.9 billion and $528.04 billion in the fourth quarter. Measured from a base of the average for the fourth quarter of 1982 to the fourth quarter of 1983, this means that $M_1$ will have grown by between 9.3 and 11.5 percent.

This would be the most growth-oriented monetary policy in postwar history. The previous peak for $M_1$ growth was 9.2 percent, reached in 1972—or 0.1 percentage-points less than the low end of the current range, measured on a fourth-quarter to fourth-quarter basis.

There are pitfalls in this growth path. We must be certain that such growth is consistent, not only with vigorous economic growth but also with reasonable price stability. But there is also an important lesson to be learned from this policy. Such stimulative monetary growth is necessary, precisely because of the unprecedented depth of the preceding recession. And these depths reflected the failure to effectively coordinate fiscal and monetary policies in 1980 and 1981. Never again can we permit such an uncoordinate, see-saw pattern to capture national economic policy. It is the business of this committee, as of the entire Congress and the Federal Reserve, to ensure that it never happens again.

This means, first, that the real factors in economic life—economic growth and reasonable price stability—must be the operative goals of monetary policy. We have tried the experiment of monetarism, in which narrow and shifting conceptions of the monetary aggregates determine the operations of monetary policy. It is clear that this approach has failed to produce its predicted results. And the recent actions of the Federal Reserve demonstrate that the Federal Reserve concurs that strict monetarist doctrine can not control the operations of monetary policy. We have learned from experience, which is all responsible policymakers can hope to do.

It is also clear that we must go on to ensure better coordination between fiscal and monetary policy in the future. We must expand the routine exchange of information regarding economic objectives and information, between the Federal Reserve and the Congress. We must have the basis to project the consequences of alternate modes of coordination—before the fact—so we never again find ourselves forced to respond, after-the-fact, to uncoordinated parts of a single economic policy.

We should all be satisfied that the Federal Reserve joins Congress in a commitment to manage national economic policy so as to avert any prospect that sharply rising interest rates will abort the current recovery. But we must explore more closely what reforms will be required to assure sustained economic growth, and growth which lifts all sectors of our economy.

However, vigorous real economic growth was in the second quarter—and the 8.7 percent real growth rate announced by the Commerce Department is indeed heartening—many dangers still lie ahead. The deficits remain in the region of $200 billion, as far as David Stockman's eye can see. The budget resolution directed that some $73 billion in additional revenues be raised to help close these deficits over the next three years, most of these revenues in fiscal year 1986. The President's Budget proposed $46 billion in new revenues in fiscal year 1986, the same figure in the budget resolution. The administration must now join Congress in supporting specific measures to raise these revenues. In this context, the spending restraints of the budget resolution can be carried out as well.

These deficits have helped maintain real interest rates in the region of 5 to 7 percent. May I tell you there is no sustained economic recovery in our history in such a real interest rate atmosphere. And the results of such real rates are predictable. The most interest-sensitive industries remain deeply depressed. Steel, once the backbone of American industrialization, has remained stalled at less than 60-percent capacity utilization for the last 5 months. Our export industries remain crippled. Our trade deficit last year hit a new record, more than $36 billion. Martin Feldstein, chairman of the President's Council of Economic Advisers, forecasts a trade deficit this year of more than $60 billion. And he sees "substantial risk" that the trade deficit for 1984 could top $100 billion.

These deficits, which will cripple our export sector, are closely related to the appreciation of the dollar on the world's foreign exchange markets. And this appreciation is directly related to the high level of US real interest rates. Since 1980, the value of the dollar has risen 40 percent against the currencies of our major trading partners, after adjustments for inflation. Since January of this year, the dollar's value has risen another 8 percent. We will not be able to redress our trade imbalance unless we bring down US real interest rates, so the over-appreciation of the dollar which cripples the ability of our products to compete effectively abroad can be reversed. This will require continuing coordination of fiscal and monetary policies.

How to achieve this coordination on a routine basis remains largely unknown. We've never tried to do so before. We've never had as great a need to do so before. The monetary policy resolutions on the last two budget resolutions were the start. These hearings are the critical next step. Permit me to mention a third course we should consider.

On April 20, 1983, I introduced legislation, with Mr. Cranston of this subcommittee, to establish a National Commission on Monetary Policy. This Commission shall be charged with investigating, not the technical operations of the Federal Reserve, which properly should be left to the Federal Reserve, but rather to what degree and in what manner fiscal and monetary policy should be coordinated on a routine basis. The Commission would investigate,

—What economic developments and factors, here and abroad, should be taken into account in fiscal and monetary policy?

—What are the costs and benefits, both economic and political, for our current arrangements, which is to say, the present coordination of fiscal and monetary policy?

—How can we achieve the degree of coordination deemed appropriate by the Commission?

—How much information about economic conditions, policy goals and intentions should be routinely exchanged by the Federal Reserve, the Congress, and the executive branch, and by what means?

—How can we best ensure that monetary policy shall be compatible with the economic objectives of Congress?

These questions would be considered by 20 members, appointed by the President. The President would name five members from the executive branch, including the Chairman of his Council of Economic Advisers who would serve as the Commission Chairman. I would also expect the President to name officials such as the Director of the Office of Management and Budget, the Under Secretary of the Treasury for Monetary Affairs, and the Under Secretary of State for Economic Affairs, who are deeply involved with these matters on a daily basis.

Each House of Congress would also recommend five members each. And the Chairman of the Board of Governors of the Federal Reserve System would recommend five members as well, drawn from current and past members of the Board and current and past presidents of the regional Federal Reserve Banks.

We are just now emerging from the worst economic downturn in more than 50 years. The human costs and economic costs were, and still are, enormous and cruel. It left us with new records for the lowest capacity utilization for American manufacturing, the highest unemployment, and the sharpest plunge in corporate profits, since the Great Depression. It helped destabilize the world banking system and nearly destroyed the world trading system. These were all consequences of a profoundly misguided combination of expansive fiscal and restrictive monetary policies. An economic program at war with itself.

We can do better. Let us find out precisely how. I commend the activities of this subcommittee in this task. Now we must go forward.

Senator GORTON. Senator Heinz.

Senator HEINZ. Mr. Chairman, I note we have 4 to 5 minutes to get over to the floor and cast our vote on 10 percent withholding. I have a few brief remarks. Might I withhold them until we return?

Senator GORTON. Yes, you certainly may. We will be back as promptly as we possibly can. Thank you, Senator Moynihan.

[Recess.]

Senator GORTON. Thank you, Mr. Chairman, for your patience. Senator Heinz does intend to come back and may have a statement at that time, but in the interest of your time, I'm delighted to ask you proceed.

## STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman, perhaps instead of reading my statement in its entirety, I could condense the points that I wanted to make in the statement.

Senator GORTON. I would be delighted to have you do that and, of course, your entire statement and the appendixes will be included in the record in full.

[Complete statement follows:]

For release on delivery
2:00 PM, E.D.T.
July 28, 1983

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Economic Policy

of the

Committee on Banking, Housing, and Urban Affairs

United States Senate

July 28, 1983

I am pleased to have this opportunity to discuss issues bearing on the coordination of monetary and fiscal policies and on the request to this Committee, contained in the First Budget Resolution, to frame a sense of the Congress resolution with respect to appropriate information bearing on the assumptions and goals of monetary policy. Chairman Garn has also requested a review of how the Federal Reserve formulates monetary policy and the types of assumptions or goals that are used in policy formulation.

Broadly stated, the goals of all our general economic policies are clear enough -- we all want to see sustained economic growth, high levels of employment, and price stability. Those general economic objectives are basic to the formulation of monetary or other policies. But, as you know, we cannot always reach all those goals in the short run or continuously, and monetary policy, by itself, cannot satisfy all of them even over time.

Fiscal, regulatory, and other policies of the government and wage and price policies in the private sector all affect economic activity, prices, productivity, and the rate of economic growth, and particularly bear upon our ability to reconcile our several goals. Moreover, the domestic economy has come to be influenced more and more by external developments. The oil price shocks are only the most obvious example. The recent problems with major debtor countries, exchange rate behavior, and economic growth in other countries, as it affects demand for our exports, all have influences on our economy in one degree or another, frequently in ways that cannot be fully, or at all, compensated for by monetary policy.

But the Federal Reserve does need to take account of these kinds of developments at home and abroad as it formulates policy, and they could affect prospects for achieving the basic economic goals of economic activity, prices, and employment within a given time frame. The fiscal policy of the Federal Government is one of the most important of those factors, but not the only one.

## The Formulation of Monetary Policy

Monetary policy is reflected mainly in decisions by the Board of Governors on the discount rate and by the Federal Open Market Committee, which normally meets eight times a year, about open market operations. The members of the Board and the Committee regularly receive a wide variety of economic and financial information about the economy in preparation for these decisions. The great bulk of that information consists of publicly available statistics, surveys, and reports, but the material is also analyzed and summarized by staff at the Board, in written documents as well as oral presentations. The staff often presents forecasts for several quarters ahead, based on a combination of econometric and judgmental techniques. Alternative forecasts may be set forth, depending upon different policy assumptions, and areas of uncertainty are emphasized. Individual members of the FOMC will also have available to them analyses and forecasts prepared at the different Federal Reserve Banks.

At meetings of the FOMC, Committee staff also usually sets forth, for purposes of discussion, alternative approaches that might be considered by the Committee in its formulation of policy decisions. This material attempts to set out the implications of possible approaches, including alternative monetary and credit targets for a year ahead, as well as an evaluation of alternative short-run approaches to attainment of such targets. These analyses suggest the direction of possible impacts on market developments, recognizing those developments may be dominated by other factors including, over time, budgetary decisions. The FOMC also reviews closely recent developments in domestic and international financial markets and the implementation of Federal Reserve operations since the last meeting.

Policy discussions center on the members' own assessments of the economic and financial outlook, and their view of its implications for the formulation of policy.

Underlying these discussions, there is common acceptance of the broad goals I stated at the start, which are, of course, incorporated in law. At the same time, individual members may well have different points of concern or emphasis in the short run, they may disagree about the outlook, and they bring to the table different conceptual or analytic emphases. For instance, some members will tend to put more weight on particular money supply developments, while others will put more stress on the developing conditions in credit markets. I believe all members consistently recognize the need to consider the implications of current policy over a considerable period of time, but, in particular situations, there will be differences as to the relative weights put on short or longer-run factors, or on price, growth, or other objectives. (I have attached in this respect records of discussion for two recent meetings. These policy records, which are released to the public about seven weeks or so after each meeting, indicate the range of economic and financial variables that are taken into account in the formulation of policy.)

These differences in approach are natural to a degree in a committee structure made up of independently appointed officials. In the end, the differences have to be reconciled in a specific operational decision. But the differences in emphasis and assumptions about the economic outlook that lie behind the decision are one reason why we have felt it more constructive to provide the Congress, in our semi-annual reports, with a range of assumptions about economic variables rather than a simple "objective" about which, in the short run at least, any consensus might well be artificial.

When setting a course for monetary policy, the Committee members take the government's fiscal policy basically as a "given." There is often, of course, a degree of uncertainty about the likely budgetary developments, particularly in the period before a budget resolution is adopted and implemented. Looking several years ahead, the uncertainties increase.

Typically, however, the dimensions of the budget can be approximated well enough to provide a reasonable basis for assessing the direction of its impact on overall economic performance and credit market conditions.

As you know, the FOMC expresses its policy intentions over time, as required by the Humphrey-Hawkins Act, in terms of monetary and credit targets. Those annual targets are expressed in ranges and attention is paid to several measures, rather than a single statistical definition of money or credit. The use of ranges rather than "point" targets reflects in part the impracticality -- and many would argue the undesirability -- of controlling monetary growth precisely. More broadly, the ranges, and the related judgment about which target or targets are more significant at particular times, provide an element of, to me appropriate, flexibility in the face of shifts in relationships of the aggregates to the economy or other unforeseen developments. The Committee can, of course, change targeted growth ranges (as was the case in July with respect to the M1 ranges) if deemed necessary or desirable in the light of events. But I believe there is, and should be, a presumption that such changes will be made only in the light of highly persuasive evidence.

The results of the FOMC's deliberations about longer-run money and credit targets, and the associated economic outlook, are presented to the Congress twice a year in the Board's "Monetary Policy Report Pursuant to the Full Employment and Balanced Growth Act of 1978." In that report, we currently provide the Congress with annual ranges of growth for M2, M3, M1, and total credit.

In addition, the Congress is given associated economic projections covering the same period for nominal GNP, real GNP, the implicit price deflator, and the unemployment rate.

In February these monetary ranges and associated economic projections are shown only for the current year. In July, the monetary ranges and projections are shown for the current year and the ensuing year.

The associated projections are shown in a range sufficient generally to encompass all Committee members, and -- beginning this year -- also for a much narrower range (labelled the "central tendency") to capture the expectations of most Committee members. These projections or forecasts reflect the views of the individual Committee members as to the implications of monetary policy decisions, as well as other factors, such as fiscal policy, but the members may not have a common view in those respects. Those projections are also compared with Administration forecasts for the same period, and they could also be compared with forecasts by the Congressional Budget Office or the assumptions that lie behind the budget resolution adopted by Congress, depending upon the time period.

These semi-annual reports to Congress, as presently structured, seem to me to provide a reasonable basis upon which the Congress can evaluate the implications of the Federal Reserve's monetary policy and to come to a view about whether monetary and fiscal policies are appropriately complementary. No doubt, they can be improved -- which I take it is one of your concerns about which I will say a few words in a moment. At the same time, I believe we should be cautious about placing too much weight -- in either monetary or fiscal policy -- upon a particular, and fallible, projection.

The uncertainties inherent in any economic forecast are one reason why the presentation of ranges of views, rather than a "point" forecast, is useful. Even so, events have, not infrequently, carried one or more economic variables outside the forecast range, and part of the policy problem is deciding how to respond to such unforeseen developments. Some unexpected changes may be favorable -- stronger growth or lower inflation -- and would not necessarily call for any adjustment in policy; others may be clearly unfavorable in terms of expectations or longer-term objectives; perhaps more frequently there will be a mixture of "good" and "bad" news. In none of these cases should it automatically be assumed that policy adjustments to reach a pre-set objective for the year are necessarily desirable.

In that connection, the essence of the policy problem is the need to look beyond any short forecast period to the longer-term cumulative effects of policy on the economy. What may appear a reasonable and desirable trade-off in the short run -- say, between more growth and less inflation, or more growth and budgetary restraint -- may well turn out to have sharply adverse effects if repeated over time.

## The "Coordination" of Fiscal and Monetary Policy

On the face of it, more "coordination" always sounds better than less -- in our fiscal and monetary affairs as in other policies. But, in concrete instances, coordination may have an ambiguous meaning. Does it mean, for example, that measures which increase a deficit should be accompanied by more rapid money growth, so that the larger deficit could presumably be readily financed for a time -- at the longer-run risk of inflation? Or does it mean that a higher deficit should be accompanied by less rapid money growth to help assure that the deficit does not generate inflationary pressures -- at the possible expense of greater near-term market pressures? Answers will depend on particular circumstances, on judgments about the relevant time frame, and other factors.

Similar questions can be asked about measures to reduce the deficit. Should the Federal Reserve raise money growth, leave it unchanged, or lower it if Congress takes steps significantly to reduce the deficit below current expectations built into the economic outlook? The answer would again depend in part on one's analytic framework, but more pragmatic answers would depend on assessment of the effects on interest rates, credit markets, and private spending of reduced Federal credit demands, the sensitivity of inflationary expectations to changes in money targets, and judgments about the trend of business activity.

As this suggests, there is no simple trade-off between fiscal and monetary policy. The budgetary decision will, of course, affect the distribution of the available supply of credit in the economy and interest rates, and the mix of consumption and investment, but monetary policy cannot automatically offset the distributional or market effects of fiscal policy.

I interpret the Congressional interest in coordination as seeking ways to elucidate these choices rather than implying a simple or fixed trade-off between fiscal and monetary policy. I also believe the present reporting framework provides an appropriate basis for such analysis and discussion, but that it could be improved in one aspect.

Specifically, during the past year, the FOMC has presented an annual range of growth for total nonfinancial debt of domestic economic sectors as one of its longer-range money and credit targets. It may be of further help to the Congress in its deliberations on the budget if, in that framework, we amplified the discussion of the implications of the budget outlook, or alternative budgetary outlooks depending on whether a budget resolution has been passed, for the distribution of debt between the private and governmental sectors and for potential credit market pressures. While I have often touched upon these matters in testimony, implications or risks with respect to the availability of credit to the mortgage market, the bond market, and other loan markets could be noted more directly in the Report itself.

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Such judgments, in the nature of things, could not be precise, and many other important factors -- the inflation outlook, the strength of economic activity, and others -- impinge strongly on credit flows and interest rates. Moreover, I do not believe a central bank should engage in the highly uncertain process of interest-rate forecasting. Within that limitation, however, I do believe our Reports could constructively be amplified in the way I have suggested.

With regard to the specific request that the Senate Banking Committee report by September 30 a sense of the Congress resolution bearing on the coordination of monetary and fiscal policy under present circumstances, I would note the economic projections in our Mid-Year Report were based on a budget assumption that is not greatly different from that contained in the most recent budget resolution, although we did factor in the contingency that some of the savings and revenue action called for in the resolution might not be achieved. The projections with respect to growth and inflation are also generally consistent with the Administration forecasts and do not differ greatly from assumptions underlying the Budget Resolution.

As I spelled out in my testimony last week, I do believe prospects for lower interest rates and for sustained and balanced recovery would be enormously assisted by more vigorous and earlier action to deal with the budgetary deficits. As things now stand, rising private credit demands, in reflection of rising private activity, are beginning to clash with the continuing heavy financing needs of the government. The FOMC has not felt that an appropriate response to that development would be still higher targets for monetary and credit growth, with the potential for greater inflation (and ultimately higher interest rates) that course could imply. More progress toward reducing the deficit would maximize the prospects, consistent with these targets, for lower interest rates over time, supporting housing and other interest-sensitive sectors of the economy in particular, and reducing the risks of credit market congestion generally.

## Targeting the GNP

The question has been raised whether "coordination" would not in some sense be better achieved if the Federal Reserve were to provide "objectives" for nominal and real GNP and prices instead of the projections we now give. I do not believe so. The issue is more than semantic. As detailed in the Appendix to this statement, a GNP objective for monetary policy would turn attention away from the role of other public and private policies in affecting economic activity and prices, promise much more than could be delivered, and risk concentration on short-term (and not readily controllable) results at the expense of continuing longer-range objectives.

I well understand that budgets must incorporate certain assumptions as to business activity, both because of the necessity for specific revenue and spending forecasts and because the timing and nature of the underlying policy decision may be influenced by the near-term outlook. But we should not lose a sense of skepticism about the accuracy of any forecast -- as illustrated by events this year. Moreover, to the extent possible, the budget outlook and structure should be evaluated independent of a particular phase of the business cycle. For instance, in making judgments looking ahead as to how much the deficit should be cut, estimates of the structural, continuing portion of the deficit are relevant.

I do not believe it wise in either monetary or fiscal policy, to commit ourselves to a particular short-term objective for, say the GNP or prices, that may or may not turn out to be attainable, and the acceptability of which may depend upon circumstances unknown at the time the objective is established.

## Conclusion

Debate and consensus about our longer-term economic objectives and methods of reaching them are inherent in the policy-making process. Through our reports and testimony, we in the Federal Reserve want to contribute constructively to that process -- and I believe we do by means of detailing our monetary policies, by setting forth our economic projections and assumptions, and by publishing and analyzing economic data and trends. As I have suggested, we could provide additional analysis on the possible effects of broad fiscal policy decisions.

We have not wished, and do not now wish, as an organization to make more specific recommendations about budgetary policy, such as the nature of saving or spending decisions, areas that are not our responsibility, although I, or others in the Federal Reserve, are sometimes asked to comment as a matter of personal opinion. I also believe we should resist the temptations to set out short-term "objectives" in such specific terms as to invite unrealistic expectations, counter-productive "fine tuning," and ultimate disappointment. Within those limitations, I look forward to working with you in responding to the request in the Budget Resolution to explore possibilities for improving the flow of information, understanding, and "coordination."

* * * * * * * * *

# FEDERAL RESERVE press release

For Use at 4:30 p.m. July 15, 1983

The Federal Reserve Board and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on May 24, 1983.

Such records for each meeting of the Committee are made available a few days after the next regularly scheduled meeting and are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary descriptions of economic and financial conditions they contain are based solely on the information that was available to the Committee at the time of the meeting.

Attachment

# RECORD OF POLICY ACTIONS OF THE FEDERAL OPEN MARKET COMMITTEE

## Meeting Held on May 24, 1983

### Domestic policy directive

The information reviewed at this meeting suggested that growth in real GNP would accelerate, perhaps rather substantially, in the current quarter, after an increase at an annual rate of about 2-1/2 percent in the first quarter. To a considerable extent, the expected pickup in growth reflected an apparently marked further slowing in the rate of inventory liquidation, with an ending of liquidation possible during the quarter. At the same time final demands for goods and services, which had strengthened in late 1982, were being relatively well maintained. The rise in average prices, as measured by the fixed-weight price index for gross domestic business product, appeared to be continuing at about the moderate pace recorded over the past year.

The index of industrial production rose 2.1 percent in April, the largest monthly increase since the summer of 1975, to a level about 6 percent above its recent trough in November. Gains in output were spread across a broad range of industries, and were particularly strong for consumer durable goods and durable goods materials. Production of business equipment, which had contracted sharply since late 1981, also rose substantially in April after turning up in March. Rates of capacity utilization in manufacturing and at materials producers increased from record lows late in 1982 to around 71 percent in April.

Nonfarm payroll employment increased more than 250,000 in April, after an increase of about 200,000 in March. Employment gains in manufacturing and service industries accounted for the bulk of the rise in both months. The civilian unemployment rate edged down further to 10.2 percent in April.

The dollar value of retail sales advanced 1.6 percent in April, about the same as in March. Outlays at apparel and furniture and appliance stores were brisk, but a major factor in the April gain was increased spending on new cars. Sales of new domestic automobiles, which had held at an annual rate of slightly over 6 million units since November, rose to a rate of 6.4 million units in April and strengthened somewhat further in early May.

Total private housing starts declined somewhat in both March and April, but at an annual rate of 1.5 million units in April, they were still about 40 percent above the depressed 1982 average. Newly issued permits for residential construction picked up in April, reflecting a marked increase in permits for multifamily units. Sales of new and existing homes increased substantially in the first quarter of 1983.

The producer price index for finished goods edged down in both March and April; prices of energy-related items, which are lagged one month in this index, declined considerably further while prices of consumer foods increased. The consumer price index rose 0.6 percent in April, after having edged up 0.1 percent in March; more than one-third of the April increase reflected the rise in gasoline prices associated with implementation of the higher federal excise tax. Thus far in 1983 the consumer price index has increased little, and the index of average hourly earnings has risen at a considerably slower pace than in 1982.

Since late March the trade-weighted value of the dollar in foreign exchange markets had remained in a narrow range near its recent high level. The U.S. foreign trade deficit in the first quarter was about one-third less than in the preceding quarter, as oil imports dropped sharply, reflecting a decline in price and a considerable reduction in volume.

At its meeting on March 28-29, 1983, the Committee had decided that open market operations in the period until this meeting should be directed at maintaining generally the existing degree of restraint on reserve positions, anticipating that such a policy would be consistent with a slowing from March to June in growth of M2 and M3 to annual rates of about 9 and 8 percent respectively. The Committee expected that growth in M1 at an annual rate of about 6 to 7 percent over the three-month period would be associated with its objectives for the broader aggregates. The Committee members agreed that lesser restraint on reserve positions would be acceptable in the context of more pronounced slowing in the growth of the monetary aggregates (after taking account of any distortions relating to the introduction of new deposit accounts) or of evidence of a weakening in the pace of economic recovery. If monetary expansion proved to be appreciably higher than expected, without being clearly explained by the effects of ongoing institutional changes, it was understood that the Committee would consult about the desirability under the prevailing circumstances of any substantial further restraint on bank reserve positions. The intermeeting range for the federal funds rate was retained at 6 to 10 percent.

Growth in M2, which had slowed to an annual rate of about 11 percent in March, decelerated further in April to an annual rate of about 3 percent.

The deceleration reflected, in part, substantial shifts of funds into individual retirement and Keogh accounts before the April 15 tax date. Growth in M3 slowed to an annual rate of about 4-1/2 percent, after expanding at an 8-1/4 percent pace in March. Partial data suggested that expansion in both M2 and M3 had picked up in early May, but growth to date still appeared to be below the annual rates of 9 and 8 percent respectively expected by the Committee for the period from March to June.

M1 declined at an annual rate of about 3 percent in April but, according to preliminary data, strengthened markedly in early May. Thus far in the second quarter, growth in M1 appeared to be running substantially above the annual rate of 6 to 7 percent deemed consistent with the Committee's expectations for the broader aggregates.

Growth in debt of domestic nonfinancial sectors appeared to have continued in April at about the same pace as in the first quarter. Over the first four months of the year, debt expansion was estimated at an annual rate of about 9-1/2 percent, well within the Committee's range of 8-1/2 to 11-1/2 percent for the year. Funds raised by the U.S. Treasury grew at about twice the rate of total debt expansion, while private debt rose at a moderate pace. Growth in total credit outstanding at U.S. commercial banks slowed somewhat in April, as banks continued to acquire sizable amounts of Treasury securities but reduced substantially their holdings of business loans.

Growth in total and nonborrowed reserves slowed appreciably in April and early May, as weakness in transaction deposits over much of March and in April was reflected with a lag in reduced demand for required reserves. Apart from large borrowings around the end-of-quarter statement date early in the intermeeting period, adjustment borrowing from the Federal Reserve discount window, including seasonal borrowing, fluctuated within a range of about $200 million to $675 million. Special factors, such as relatively sizable weekend borrowing associated with wire transfer problems, contributed at times to increased demands for borrowing. Excess reserves also continued to be volatile and were relatively high on average. Federal funds generally traded in a range of 8-1/2 to 8-3/4 percent during the intermeeting interval.

Market interest rates changed little on balance over the intermeeting interval. Short-term interest rates declined about 1/4 percentage point while most long-term rates were slightly lower or up only marginally. Market rates had fallen considerably in the early part of the period but had risen again most recently, as growth in the monetary aggregates seemed to be strenthening, signs of economic recovery became more widespread, and prospects increased that private credit demands would strengthen while Treasury borrowing remained exceptionally large. Average rates on new commitments for fixed-rate conventional home mortgage loans at savings and loan associations fell about 30 basis points further.

The staff projections presented at this meeting indicated that growth in real GNP in the second half of the year would be a little higher than had been expected, though probably slowing somewhat from the second-quarter pace. Recent evidence, including increased spending for business equipment, strength in new orders at durable goods manufacturers, and survey reports of marked improvement in consumer attitudes, suggested somewhat stronger private final demands from businesses and consumers than had been anticipated previously. The unemployment rate was projected to decline only modestly from its recent high level, and the rise in the average level of prices was expected to remain moderate.

In the Committee's discussion of the economic situation and outlook, a number of members expressed general agreement with the staff projection, but several emphasized that economic activity might well prove to be stronger than projected, especially during the quarters immediately ahead. Members observed that consumer sentiment appeared to have improved considerably, and that retail sales should benefit from the increased market value of financial asset portfolios as well as from the federal tax cut at midyear. A turnaround from sharp inventory liquidation to little change, or possibly even some accumulation, was seen as likely and would have a pronounced positive impact on GNP and on income flows, at least for a quarter or two. Members also commented that an increasingly stimulative fiscal policy would add strength to the recovery over the period ahead, and an unduly large federal deficit was likely to create problems later as private credit demands expanded.

While all Committee members anticipated continuing and possibly substantial improvement in economic activity over the months ahead, a number also questioned the balance and sustainability of the recovery. They noted that, though business capital spending was showing signs of reviving, it would need to improve markedly further to foster an extended recovery. Such spending could be inhibited if a continuing need to finance large federal deficits engendered rising interest rates as the recovery proceeded. The outlook for exports was also thought to be relatively weak, although exports should eventually improve if the foreign exchange value of the dollar were to decline substantially and if major disturbances in international financial markets were averted. One member commented that housing activity could be less strong than was widely anticipated and another observed that consumer spending could prove to be disappointing, particularly if consumers did not react more positively to the approaching tax cut than they had to the 1982 reduction. Another member commented that recent indications of a more vigorous recovery might reflect mainly a short-lived inventory adjustment.

Other members expressed a differing view and emphasized that the prospects for an extended recovery were relatively favorable. In support of this view it was observed that substantial improvements in consumer spending and inventory investment were likely to be followed by increasing capital investment, in the pattern characteristic of earlier cyclical expansions. In this connection some members stressed that the expansion might well gather momentum and prove to be much stronger than the staff was projecting, partly because the recovery would follow a relatively long and severe recession.

At this meeting the Committee reviewed the monetary growth ranges that it had established in February for the year 1983. It decided not to change any of the ranges or the relative importance of the various aggregates for policy, pending a further review at the July meeting. Growth of the broader aggregates appeared to be within the Committee's ranges for the year. Earlier in the year, growth of M2 had been affected to a major extent by large shifts of funds associated with the introduction of money market deposit accounts; such shifts had slackened substantially, although MMDAs were still expanding at a somewhat faster rate than the staff had projected earlier. M1 had grown substantially in excess of the Committee's expectations in the latter part of 1982 and the first quarter of 1983. Staff analysis based on recent research suggested that this earlier growth reflected to a substantial extent lagged responses to the decline in interest rates that began during the summer of 1982. That decline had enhanced the attractiveness of NOW accounts, which serve as a vehicle for savings as well as for transactions. The performance of M1 would continue to be affected by substantial uncertainties relating to the interest and income sensitivity of fixed-ceiling NOW accounts and also by the growing importance in M1 of the more recently introduced Super NOW accounts, which bear a market-related rate of interest. While the effects of earlier declines in interest rates should now be diminishing, given the relative stability of rates over recent months, some time would be needed to evaluate the evolving role of M1 as a vehicle for savings.

Turning to policy for the short run, the members noted a staff analysis which suggested that maintenance of the existing degree of restraint on reserve positions might be associated with second-quarter growth of M2 and M3 marginally below the rates established by the Committee at the previous meeting, but with expansion of M1 above the level anticipated by the Committee, given the surge in M1 growth during the first part of May. The staff analysis also indicated that, within limits, alternative policy courses would have relatively little impact on the second-quarter growth of the monetary aggregates in light of the limited time remaining in the quarter, but would affect their growth more substantially over the months ahead.

In the course of their discussion, Committee members expressed differing views with regard to the appropriate course for policy in the weeks immediately ahead. The members were narrowly divided between those who favored some increase in reserve restraint over the next few weeks and others who preferred to maintain the degree of reserve restraint contemplated at the March meeting. This divergence reflected varying assessments of the strength and sustainability of the economic recovery; differing views with regard to the interpretation of the monetary aggregates; and different opinions concerning the risks associated with the likely impact of alternative policy courses on domestic interest rates. Members also noted the potential sensitivity of international financial conditions and the foreign exchange value of the dollar to firmer credit conditions in the United States, suggesting for some a dilemma for monetary policy stemming in substantial part from the budgetary situation.

Members who supported retention of the current short-run policy emphasized that the growth of the broader monetary aggregates, on which the Committee had focused, was within the Committee's 1983 ranges for the year to date. Moreover, such growth seemed to be falling a bit short of the second-quarter targets that the Committee had set at the previous meeting. Expansion in total domestic nonfinancial debt also appeared to be within the range for 1983 that the Committee had established for monitoring purposes. M1 clearly was growing at a pace well above the Committee's expectations, but many members continued to view that aggregate as an unreliable guide for policy and they preferred to give little or no weight to its performance, at least for the present.

A number of members were also concerned that under current circumstances even a modest tightening of reserve conditions might have a disproportionate impact on sentiment in domestic and international financial markets and lead to sizable increases in domestic interest rates. In their view increases in interest rates would have adverse consequences for interest-sensitive sectors of the economy and possibly for the sustainability of the economic recovery. Indeed, one member believed that lower interest rates were likely to be needed to ensure continued economic expansion. Moreover, appreciably higher U.S. interest rates might have particularly damaging consequences internationally by raising the foreign exchange value of the dollar and intensifying the severe pressures on countries with serious external debt problems.

Other Committee members, however, weighed the risks associated with alternative policy courses differently. They felt that at least limited tightening of reserve conditions was desirable in light of the very rapid growth in M1 against the background of accumulating evidence that the economic recovery was accelerating. While, consistent with previous decisions, M1 was not given so much weight as a monetary policy target as it had had earlier, a number of members nonetheless saw a need to move toward restraining its growth, which clearly was running well above the pace for the second quarter that the Committee had expected would be consistent with the behavior of the broader aggregates.

Several members commented that slightly greater restraint on reserves would be desirable at this point to minimize the possible need for more substantial restraint later, reducing the interest rate impact on financial markets over time and helping to sustain the expansion. Reference was made to the favorable effect such a move might have on market perceptions about monetary policy and the outlook for containing inflation, with the consequence that prospects for stable or declining interest rates in long-term debt markets would be enhanced as the recovery proceeded. The view was also expressed that the external debt difficulties of a number of foreign countries were continuing problems. The Federal Reserve could best contribute to the resolution of those problems by following policies that would foster sustained, noninflationary economic growth. Deferring any action could well pose a greater dilemma at a later time.

At the conclusion of the Committee's discussion, a majority of the members indicated that they favored marginally more restraint on reserve positions for the near term. Although these members differed on the precise degree of additional restraint that they preferred, they indicated their acceptance of a directive calling for only slightly more restraint on reserve positions than had been approved at the previous meeting. It was understood that at this point M2 and M3 seemed to be on courses that would bring their growth to slightly below the rates of 9 and 8 percent respectively that had been set at the March meeting for the second quarter, but that M1 would probably expand at a rate well above the growth that had been anticipated for the quarter. The members agreed that lesser restraint would be appropriate in the context of more pronounced slowing in the growth of the broader monetary aggregates within their 1983 ranges and deceleration of M1 growth, or of indications that the pace of the economic recovery was weakening. It was understood that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee, would remain at 6 to 10 percent.

At the conclusion of its discussion, the Committee issued the following domestic policy directive to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that growth in real GNP has accelerated in the current quarter following a moderate increase in the first quarter. Industrial production increased sharply in April after rising at a moderate pace in previous months; nonfarm payroll employment and retail sales rose considerably in March and April. Housing starts declined somewhat in both months but were still well above depressed 1982 levels. Data on new orders and shipments suggest that the demand for business equipment is reviving. The civilian unemployment rate edged down to 10.2 percent in April. Average prices have changed little and the index of average hourly earnings has risen at a much reduced pace in the early months of 1983.

The weighted average value of the dollar against major foreign currencies has remained in a narrow range near its recent high level since late March. The U.S. foreign trade deficit fell substantially in the first quarter, reflecting a sharp drop in the value of oil imports.

Growth in M2 and M3 decelerated further in April to relatively low rates but appears to have picked up recently. M1 declined in April but has strengthened markedly in early May. Growth in debt of domestic nonfinancial sectors appears to have been moderate over the first four months of the year. Interest rates have changed little on balance since late March.

The Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation further, promote a resumption of growth in output on a sustainable basis, and contribute to a sustainable pattern of international transactions. At its meeting in February the Committee established growth ranges for monetary and credit aggregates for 1983 in furtherance of these objectives. The Committee recognized that the relationships between such ranges and ultimate economic goals have been less predictable over the past year; that the impact of new deposit accounts on growth ranges of monetary aggregates cannot be determined with a high degree of confidence; and that the availability of interest on large portions of transaction accounts, declining inflation, and lower market rates of interest may be reflected in some changes in the historical trends in velocity. A substantial shift of funds into M2 from market instruments, including large certificates of deposit not included in M2, in association with the extraordinarily rapid buildup of money market deposit accounts, distorted growth in that aggregate during the first quarter.

In establishing growth ranges for the aggregates for 1983 against this background, the Committee felt that growth in M2 might be more appropriately measured after the period of highly aggressive marketing of money market deposit accounts had subsided. The Committee also felt that a somewhat wider range was appropriate for monitoring M1. Those growth ranges were to be reviewed in the spring and altered, if appropriate, in the light of evidence at that time. The Committee reviewed the ranges at this meeting and decided not to change them at this time, pending further review at the July meeting. With these understandings, the Committee established the following growth ranges: for the period from February-March of 1983 to the fourth quarter of 1983, 7 to 10 percent at an annual rate for M2, taking into account the probability of some residual shifting into that aggregate from non-M2 sources; and for the period from the fourth quarter of 1982 to the fourth quarter of 1983, 6-1/2 to 9-1/2 percent for M3, which appeared to be less distorted by the new accounts. For the same period a tentative range of 4 to 8 percent was established for M1, assuming that Super NOW accounts would draw only modest amounts of funds from sources outside M1 and assuming that the authority to pay interest on transaction balances was not extended beyond presently eligible accounts. An associated range of growth for total domestic nonfinancial debt was estimated at 8-1/2 to 11-1/2 percent.

In implementing monetary policy, the Committee agreed that substantial weight would continue to be placed on behavior of the broader monetary aggregates expecting that distortions in M2 from the initial adjustment to the new deposit accounts will abate. The behavior of M1 will continue to be monitored, with the degree of weight placed on that aggregate over time dependent on evidence that velocity characteristics are resuming more predictable patterns. Debt expansion, while not directly targeted, will be evaluated in judging responses to the monetary aggregates. The Committee understood that policy implementation would involve continuing appraisal of the relationships between the various measures of money and credit and nominal GNP, including evaluation of conditions in domestic credit and foreign exchange markets.

The Committee seeks in the short run to increase only slightly the degree of reserve restraint. The action was taken against the background of M2 and M3 remaining slightly below the rates of growth of 9 and 8 percent, respectively, established earlier for the quarter and within their long-term ranges, M1 growing well above anticipated levels for some time, and evidence of some acceleration in the rate of business recovery. Lesser restraint would be appropriate in the context of more pronounced slowing of growth in the broader monetary aggregates relative to the paths implied by the long-term ranges and deceleration of M1, or indications of a weakening in the pace of economic recovery. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that pursuit of the monetary objectives and related reserve paths during the period before the next meeting is likely to be associated with a federal funds rate persistently outside a range of 6 to 10 percent.

Votes for this action: Messrs. Volcker, Gramley, Keehn, Martin, Partee, Roberts, and Wallich. Votes against this action: Messrs. Solomon, Guffey, Morris, Rice, and Mrs. Teeters.

Messrs. Solomon, Guffey, Morris, Rice, and Mrs. Teeters dissented from this action because they wanted open market operations to continue being directed toward maintaining approximately the degree of reserve restraint approved at the previous meeting. In the view of these members, a firming of reserve conditions was not warranted by the performance of the monetary aggregates or by the current economic situation. M2 and M3 were expanding more slowly in the second quarter than the Committee had anticipated at its previous meeting and for the year to date these broader aggregates, along with total domestic nonfinancial credit, were growing at rates that were within the Committee's 1983 ranges. M1 had been expanding at a pace markedly in excess of the Committee's expectations in recent weeks and for the year to date, but this aggregate was not viewed as a sufficiently reliable guide for policy, at least for the present, since its performance was substantially distorted by various developments and it was not predictably related to nominal GNP.

Under current economic and financial circumstances, the implementation of firmer reserve conditions would also incur an undue risk of an exaggerated reaction in domestic and international financial markets. Substantially higher domestic interest rates would have damaging consequences for interest-sensitive industries and could limit the recovery in economic activity. These members agreed that current interest rate levels appeared to be more consistent with continuing economic expansion in the months immediately ahead, but Mrs. Teeters believed that lower interest rates might well be needed later to sustain the recovery.

These members also referred to the potentially disruptive international impact of rising U.S. interest rates. Messrs. Solomon, Guffey, and Morris in particular believed that the already strong dollar in foreign exchange markets, the tenuous situation of some of the developing countries, the still fragile economic recovery in other industrial countries, and the continuing weak outlook for U.S. exports counseled against an increase in reserve restraint.

On June 23 the Committee held a telephone conference to review recent developments in the domestic and international economy and financial markets since the May 24 meeting. Evidence suggested that economic activity was continuing to strengthen at a somewhat more rapid pace than had generally been anticipated earlier. Some interest rates had increased modestly in recent weeks. Growth in monetary aggregates, particularly M1, had been relatively rapid although growth in M2 and M3 remained close to the targets established for the quarter as a whole.

Against that background, the consensus was that a modest increase in reserve restraint, within the framework of the directive adopted at the May 24 meeting and consistent with recent reserve conditions, remained appropriate.

# FEDERAL RESERVE press release

For Use at 4:30 p.m. May 27, 1983

The Federal Reserve Board and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on March 28-29, 1983. This record also includes policy actions taken during the period between the meeting on March 28-29, 1983, and the next regularly scheduled meeting held on May 24, 1983.

Such records for each meeting of the Committee are made available a few days after the next regularly scheduled meeting and are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary descriptions of economic and financial conditions they contain are based solely on the information that was available to the Committee at the time of the meeting.

Attachment

# RECORD OF POLICY ACTIONS OF THE FEDERAL OPEN MARKET COMMITTEE

## Meeting Held on March 28-29, 1983

### 1. Domestic policy directive

Based on partial information available for the first quarter, it appeared that real GNP rose moderately in the first three months of the year, following a decline at an annual rate of about 1 percent in the fourth quarter of 1982. The turnaround in economic activity reflected a considerable slowing in the pace of inventory liquidation. Meanwhile, private final sales in real terms, which had risen in the fourth quarter, continued to increase. The rise in average prices, as measured by the fixed-weight price index for gross domestic business product, slowed further.

Final sales were sustained by a marked strengthening in housing activity in early 1983. Private housing starts rose to an average annual rate of 1.7 million units in January and February, up nearly 40 percent from the pace in the fourth quarter. Newly issued permits for residential construction also rose substantially over the two-month period. Sales of new homes increased in January, the latest month for which data were available; although sales of existing homes dipped in February, they were appreciably higher in the first two months combined than in the fourth quarter.

Other elements of final sales were not quite so strong on balance as in the fourth quarter of last year. Personal consumption expenditures continued to expand in early 1983, but at a slower rate than in the previous quarter. The nominal value of retail sales fell in January and February, primarily reflecting declines in sales at automotive outlets, gasoline stations, and furniture and appliance stores, although sales at general merchandise and apparel stores rose appreciably from their level in the fourth quarter. Sales of new domestic automobiles continued at an annual rate of about 6.1 million units, the same as in the fourth quarter.

Spending for business fixed investment has remained weak in recent months. Shipments of nondefense capital goods fell sharply in January and edged down further in February, and new orders dropped appreciably in February after firming for several months. Outlays for nonresidential construction increased in January, but high vacancy rates for office buildings and the reduced drilling activity associated with declining oil prices apparently have damped such expenditures recently. The Department of Commerce survey taken in late January and February indicated that in 1983 business outlays for plant and equipment would decline about 1-3/4 percent in nominal terms, about the same as in 1982.

Nonfarm payroll employment rose about 150,000 on balance over January and February, after an extended period of declines. The month-to-month employment figures, which showed a substantial rise in January and a decline in February, were distorted by unusual weather patterns. But employment in manufacturing--particularly in the auto and related metals industries--increased in both months. The civilian unemployment rate was unchanged in February at 10.4 percent. Industrial production has risen at an annual rate of about 7-1/4 percent since its trough in November, less than the average pace in the early stages of previous cyclical recoveries.

The producer price index for finished goods fell nearly 1 percent over the first two months of the year, reflecting sharp declines in prices of energy-related items. The consumer price index was virtually unchanged over the period, as a substantial drop in prices of gasoline and other petroleum products was about offset by moderate increases in prices of most other commodities and services. Food prices have changed little thus far in 1983 and in February were only 2 percent above their level a year earlier.

The advance in the index of average hourly earnings has slowed further in recent months. With productivity apparently continuing to improve in early 1983, cost pressures in the nonfarm business sector have abated further

In foreign exchange markets the trade-weighted value of the dollar had risen about 2 percent on balance since the Committee's meeting in February. The U.S. merchandise trade deficit declined marginally in January. Exports rose somewhat and total imports continued at about the fourth-quarter rate, as oil imports dropped sharply while non-oil imports strengthened.

At its meeting on February 8-9, 1983, the Committee established the following ranges for growth of the monetary aggregates: for the period from February-March of 1983 to the fourth quarter of 1983, 7 to 10 percent at an annual rate for M2, taking into account the probability of some residual shifting into that aggregate from non-M2 sources; and for the period from the fourth quarter of 1982 to the fourth quarter of 1983, 6-1/2 to 9-1/2 percent for M3, which appeared to be less distorted by shifts associated with new deposit accounts. For the same period, a tentative range of 4 to 8 percent was established for M1, assuming that Super NOW accounts would draw only modest amounts of funds from sources outside M1 and that the authority to pay interest on transaction accounts would not be extended beyond currently eligible accounts. An associated range of growth for total domestic nonfinancial debt was estimated at 8-1/2 to 11-1/2 percent.

At the February meeting, the Committee agreed that the near-term outlook for growth in the monetary aggregates remained subject to unusual uncertainties and that an appropriate assessment of such growth would need to take account of the distortions that might continue to be created by the introduction of new deposit accounts. Consequently, the Committee decided that open market operations in the period until this meeting should be directed toward maintaining the existing degree of restraint on reserve positions. It was agreed that lesser restraint would be acceptable in the context of appreciable slowing of growth in the monetary aggregates, to or below the paths implied by the long-term ranges.

M2 grew at an estimated annual rate of about 24 percent in February, only a little below the exceptional pace in January, as its growth continued to be greatly affected by shifts of funds from market instruments and other non-M2 sources into the new money market deposit accounts (MMDAs) included in M2. M3 grew at annual rates of about 12 and 13-1/2 percent in January and February respectively. However, growth in both of the broader aggregates appeared to have decelerated substantially during March. The deceleration reflected in part a marked slowing in the volume of funds shifted into MMDAs from market instruments and apparently also a moderation in the underlying growth of the nontransaction component of these aggregates. Growth in M1 accelerated to an extraordinary annual rate of about 22 percent in February, and, on the basis of preliminary data, was estimated to have remained rapid in March, though probably slowing somewhat from the February rate. An acceleration in growth of NOW accounts and a large increase in holdings of currency contributed to the expansion in M1. The income velocity of M1 apparently declined sharply in the first quarter, continuing the trend that became evident in the course of 1982.

Total and nonborrowed reserves declined appreciably in February, but turned up in March. The behavior of reserves did not reflect the strength in the aggregates largely because required reserves at member banks were lowered by shifts out of personal savings and small time deposits into nonreservable MMDAs and there was an associated runoff of large-denomination CDs. The monetary base grew considerably more than the reserve measures, owing to the rapid expansion of currency in circulation. Adjustment borrowing (including seasonal borrowing) fluctuated between $140 million and $600 million over the intermeeting period. Excess reserves were also volatile and were somewhat higher than usual on average; strong demands for excess reserves at times appeared to be related to slow responses by banks to reductions in reserve requirements. Federal funds continued to trade near the 8-1/2 percent discount rate over most of the intermeeting interval, though rising to around 8-3/4 percent in the week prior to this meeting.

Most short-term market interest rates rose about 3/8 percentage point over the intermeeting interval, while bond rates declined about 3/8 to 1/2 percentage point. The average rate on new commitments for fixed-rate conventional home mortgage loans at savings and loan associations declined 20 basis points further. At the end of February, the prime rate charged by most commercial banks on short-term business loans was reduced by 1/2 percentage point to 10-1/2 percent.

Total credit outstanding at U.S. commercial banks, which had grown at an annual rate of about 6 percent in the fourth quarter of 1982, expanded at an average annual rate of about 10 percent over the first two months of this year. Banks acquired a sizable volume of securities, particularly Treasury securities, and also expanded their loans somewhat. Very preliminary data suggested that the total debt of domestic non-financial sectors was increasing in early 1983 at a rate near the lower end of the Committee's estimated range for the year. There was a sharp increase in the share of debt financed through depository institutions, which had experienced massive inflows of funds as a result of aggressive marketing of the newly authorized MMDAs.

Staff projections presented at this meeting indicated that real GNP would probably grow at a moderate pace throughout 1983, with unemployment remaining high. Private final purchases were projected to pick up somewhat in the latter half of the year, partly in response to the third phase of the tax cut. It was anticipated that the liquidation of business inventories would end by midyear and that some restocking of depleted inventories would occur in the second half. The rise in the average level of prices was expected to remain moderate, even as economic recovery proceeded over the balance of 1983, given the favorable outlook for oil prices and the prospects for continued limited increases in unit labor costs.

In the Committee's discussion of the economic situation and outlook, the members agreed that a recovery in economic activity appeared to be under way, although several commented that the evidence available thus far was too fragmentary to permit a firm evaluation of the strength of the upturn. While the staff projection of moderate growth for 1983 as a whole was cited as a reasonable expectation, members commented on the many uncertainties surrounding the economic outlook and expressed differing views regarding the direction of possible deviations from the staff projection.

Some members saw the staff projection as the middle of a plausible range of possible outcomes for 1983, given the outlook for fiscal and monetary policy. Several members believed, however, that the risks of a deviation were in the direction of a shortfall. These members stressed potential obstacles to a vigorous recovery. These included the possibility of further unsettlement in international and domestic financial markets, the outlook for poor export markets, and the prospects for continuing weakness in business investment, at least over the quarters immediately ahead, against the backdrop of low capacity utilization rates in industry and recent overbuilding of many types of commercial properties. Reference was also made to the retarding impact of relatively high real interest rates, and some members expressed the view that an appreciable rise in interest rates, if such a rise were to occur, could greatly inhibit the recovery in interest-sensitive sectors of the economy, such as housing and automobiles which had tended to lead the recovery thus far.

A differing view was expressed which stressed the possibility of a stronger recovery that, like many previous recoveries in the postwar period, would tend to gather momentum as it developed. In support of this view, it was noted that private final purchases had risen appreciably in the fourth and first quarters, and such purchases could strengthen markedly further in reaction to the federal tax cut at midyear and anticipated improvement in business spending. Moreover, cutbacks in inventories had been unusually pronounced during the recession, so that gains in consumer spending would tend to be translated directly into increased production.

Members referred to the favorable outlook for prices in 1983, partly associated with an improved trend in productivity and reduced wage-cost pressures, but some members also commented that the longer-run outlook for inflation and for a sustainable recovery would be influenced greatly by progress in holding down future federal deficits and by success in achieving the Committee's objectives for monetary growth. It was noted that the effects of an expansionary federal budget would be offset to some extent by efforts of state and local governments to curb expenditures and to raise taxes. On balance, however, it appeared that markets remained apprehensive about the outlook for the federal budget, and that concern was reflected in continued pressures on interest rates, especially in long-term debt markets.

In discussing a policy course for the weeks immediately ahead, Committee members recognized that substantial uncertainties affected both the economic outlook and the interpretation of the monetary aggregates. Concern was expressed about the implications of the rapid growth in the monetary aggregates, particularly if it should continue. However, it was also noted that the rapid expansion of recent months, given the distortions related to various institutional changes, probably did not have the significance for future economic and price developments that it might have had in the past. It was generally recognized that much of the recent growth in the broad aggregates, especially M2, reflected shifts of investment preferences by individuals away from market instruments toward the new MMDAs, given the very attractive rates being offered on the accounts by depository institutions in a highly competitive environment. Note was also taken of the marked slowing in monetary growth that appeared to be in train for March, and of a staff analysis suggesting that underlying growth of the broad aggregates--as well as growth in M1--might be moderate in the months ahead as the lagged effects of earlier declines in market interest rates dissipated. With respect to M1, most members felt that persistence of its unusual sharp decline in velocity early this year cast doubt on the aggregate as a principal guide for policy at this time; however, a view was also expressed in favor of giving M1 more weight in the formulation of the Committee's policy.

In evaluating the overall financial situation, it was also pointed out that the strength of the aggregates needed to be judged in the context of the apparently moderate expansion of domestic nonfinancial debt and of the relatively high level of real interest rates. With the economic recovery still in its early and fragile stages, the view was expressed that strong upward pressures on interest rates would involve an unacceptable risk of unduly retarding, and perhaps aborting, the recovery. The view was also expressed that a sustainable recovery might not develop at the present levels of nominal and real interest rates. On the other hand, no member expressed sentiment for a substantial easing in the existing degree of reserve restraint in the absence of clear evidence of a pronounced slowing in monetary growth or of indications that the economic recovery was faltering.

While a few members indicated a preference for leaning in the direction of slightly more, or slightly less, restraint on reserve positions in the period immediately ahead--depending on their assessment of the economic outlook, credit conditions, and the monetary aggregates--all of the members found acceptable a policy calling for maintaining generally the current degree of reserve restraint, pending the availability of further evidence on the behavior of the monetary aggregates and on the economic situation. The members anticipated that such a policy course would be consistent with substantial slowing in the growth of M2 and M3 to annual rates of about 9 percent and 8 percent respectively over the period from March to June; these growth rates assumed that shifts of funds into the new deposit accounts from market instruments would have only a relatively small further impact on the broad aggregates--perhaps no more than a percentage point or so in the case of M2. The Committee also expected that M1 growth at an annual rate of about 6 to 7 percent over the three-month period would be associated with its objectives for the broader aggregates, assuming basically no distortion in M1 on balance from the newly introduced accounts. Should these assumptions about distortions from the new accounts prove to be incorrect, it was understood that appropriate adjustments would have to be made in the monetary growth objectives.

The Committee members agreed that lesser restraint on reserve positions would be acceptable in the context of more pronounced slowing in the growth of the monetary aggregates, after taking account of any distortions relating to the introduction of new deposit accounts, or of evidence of a weakening in the pace of the economic recovery. If monetary expansion proved to be appreciably higher than expected, without being clearly explained by the effects of ongoing institutional changes, it was understood that the Committee would consult about the desirability under the prevailing circumstances of any substantial further restraint on bank reserve positions. It was further understood that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee, would be retained at 6 to 10 percent.

At the conclusion of its discussion, the Committee issued the following domestic policy directive to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that real GNP rose moderately in the first quarter, after a decline in the fourth quarter; the turnaround reflects a considerable slowing in inventory liquidation. Private final sales apparently increased only slightly less than in the fourth quarter with housing activity strengthening further. Business fixed investment has remained weak. Nonfarm payroll employment rose on balance in January and February, after an extended period of declines; the civilian unemployment rate was unchanged in February at 10.4 percent. In early 1983 the rise in average prices and the advance in the index of average hourly earnings have slowed further.
>
> The weighted average value of the dollar against major foreign currencies rose somewhat on balance between early February and late March. The U.S. merchandise trade deficit declined marginally in January.
>
> M2 continued to grow at an exceptional rate in February and M3 also expanded at a rapid pace, but growth in both of the broader aggregates appears to be decelerating substantially in March. The deceleration reflects in part the marked slowing in growth of money market deposit accounts (MMDAs) in recent weeks and apparently also a moderation in the underlying growth of these aggregates, abstracting from shifts from market instruments. M1 has expanded rapidly since late January, largely reflecting accelerated growth in NOW accounts. Growth in debt of domestic nonfinancial sectors appears to have been moderate

in the first quarter. Short-term interest rates have risen somewhat since early February while long-term rates, including mortgage rates, have declined.

The Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation further, promote a resumption of growth in output on a sustainable basis, and contribute to a sustainable pattern of international transactions. At its meeting in February the Committee established growth ranges for monetary and credit aggregates for 1983 in furtherance of these objectives. The Committee recognized that the relationships between such ranges and ultimate economic goals have been less predictable over the past year; that the current impact of new deposit accounts on growth rates of monetary aggregates cannot be determined with a high degree of confidence; and that the availability of interest on large portions of transaction accounts, declining inflation, and lower market rates of interest may be reflected in some changes in the historical trends in velocity. A substantial shift of funds into M2 from market instruments, including large certificates of deposit not included in M2, in association with the extraordinarily rapid build-up of money market deposit accounts, has distorted growth in that aggregate during the first quarter.

In establishing growth ranges for the aggregates for 1983 against this background, the Committee felt that growth in M2 might be more appropriately measured after the period of highly aggressive marketing of money market deposit accounts has subsided. The Committee also felt that a somewhat wider range was appropriate for monitoring M1. Those growth ranges will be reviewed in the spring and altered, if appropriate, in the light of evidence at that time.

With these understandings, the Committee established the following growth ranges: for the period from February-March of 1983 to the fourth quarter of 1983, 7 to 10 percent at an annual rate for M2, taking into account the probability of some residual shifting into that aggregate from non-M2 sources; and for the period from the fourth quarter of 1982 to the fourth quarter of 1983, 6-1/2 to 9-1/2 percent for M3, which appeared to be less distorted by the new accounts. For the same period a tentative range of 4 to 8 percent was established for M1, assuming that Super NOW accounts would draw only modest amounts of funds from sources outside M1 and assuming that the authority to pay interest on transaction balances is not extended beyond presently eligible accounts. An associated range of growth for total domestic nonfinancial debt was estimated at 8-1/2 to 11-1/2 percent.

In implementing monetary policy, the Committee agreed that substantial weight would be placed on behavior of the broader monetary aggregates, expecting that distortions in M2 from the initial adjustment to the new deposit accounts will abate. The behavior of M1 will be monitored, with the degree of weight placed on that aggregate over time dependent on evidence that velocity characteristics are resuming more predictable patterns. Debt expansion, while not directly targeted, will be evaluated in judging responses to the monetary aggregates. The Committee understood that policy implementation would involve continuing appraisal of the relationships between the various measures of money and credit and nominal GNP, including evaluation of conditions in domestic credit and foreign exchange markets.

For the short run, the Committee seeks to maintain generally the existing degree of restraint on reserve positions, anticipating that would be consistent with a slowing from March to June in growth of M2 and M3 to annual rates of about 9 and 8 percent, respectively. The Committee expects that M1 growth at an annual rate of about 6 to 7 percent would be consistent with its objectives for the broader aggregates. Lesser restraint would be acceptable in the context of more pronounced slowing of growth in the monetary aggregates relative to the paths implied by the long-term ranges (taking account of the distortions relating to the introduction of new accounts), or indications of a weakening in the pace of economic recovery. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that pursuit of the monetary objectives and related reserve paths during the period before the next meeting is likely to be associated with a federal funds rate persistently outside a range of 6 to 10 percent.

Votes for this action:
Messrs. Volcker, Solomon, Gramley,
Guffey, Keehn, Martin, Morris,
Partee, Rice, Roberts, Mrs. Teeters,
and Mr. Wallich. Votes against this
action: None.

## 2. Review of continuing authorizations

The Committee followed its customary practice of reviewing all of its continuing authorizations and directives at this first regular meeting of the Federal Open Market Committee following the election of new members from the Federal Reserve Banks to serve for the year beginning March 1, 1983. The Committee reaffirmed the authorization for foreign currency operations, the foreign currency directive, and the procedural instructions with respect to foreign currency operations in the forms in which they were currently outstanding.

> Votes for these actions: Messrs. Volcker, Solomon, Gramley, Guffey, Keehn, Martin, Morris, Partee, Rice, Roberts, Mrs. Teeters and Mr. Wallich. Votes against these actions: None.

## 3. Authorization for domestic open market operations

On the recommendation of the Manager for Domestic Operations, System Open Market Account, the Committee amended paragraph 1(a) of the authorization for domestic open market operations to raise from $3 billion to $4 billion the limit on intermeeting changes in System account holdings of U.S. government and federal agency securities. The Manager noted that in recent years the Committee had found it necessary to authorize temporary increases in the limit with greater frequency because of the longer intervals between Committee meetings and the increased size of the net variation in market factors affecting reserves. In 1981 and 1982, such temporary increases had been authorized in half of the intermeeting periods. A permanent increase in the limit to $4 billion would reduce the number of occasions requiring special Committee action, while still calling to the

Committee's attention needs for particularly large changes. The Committee concurred in the Manager's view that such an increase would be appropriate.

The Committee also approved the deletion of paragraph 2 of the authorization which had authorized, under certain conditions, the direct lending of securities held in the System account to the U.S. Treasury and the purchase of special short-term certificates of indebtedness directly from the Treasury. Paragraph 2 had been in a state of de facto suspension since June 1981 when the statutory authority on which it was based expired. In the past, the Congress had enacted the legislation for limited periods and occasionally had allowed it to lapse prior to its renewal. Since no legislation to renew the authority was under consideration, the Committee concurred in a staff recommendation to delete paragraph 2 and renumber the remaining paragraphs in the authorization.[1]

Accordingly, effective March 28, 1983, the authorization for domestic open market operations was amended to read as follows:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U. S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System

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[1] The following conforming amendments to other Committee documents were also approved: deletion of section 270.4(d) of the Regulation Relating to Open Market Operations of Federal Reserve Banks and redesignation of the remaining paragraph as 270.4(d); and deletion of paragraph 2 of the Resolution of Federal Open Market Committee Authorizing Certain Actions by Federal Reserve Banks during an Emergency, and renumbering of remaining paragraphs.

Open Market Account at market prices, and, for such Account, to exchange maturing U. S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U. S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $4.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) When appropriate, to buy or sell in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates, prime bankers acceptances with maturities of up to nine months at the time of acceptance that (1) arise out of the current shipment of goods between countries or within the United States, or (2) arise out of the storage within the United States of goods under contract of sale or expected to move into the channels of trade within a reasonable time and that are secured throughout their life by a warehouse receipt or similar document conveying title to the underlying goods; provided that the aggregate amount of bankers acceptances held at any one time shall not exceed $100 million;

(c) To buy U. S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers acceptances of the types authorized for purchase under 1(b) above, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U. S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U. S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(c), repurchase agreements in U. S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

Votes for these actions:
Messrs. Volcker, Solomon, Gramley,
Guffey, Keehn, Martin, Morris,
Partee, Rice, Roberts, Mrs. Teeters,
and Mr. Wallich. Votes against these
actions: None.

Subsequently, on May 9-10, 1983, members of the Committee voted to increase from $4 billion to $5 billion the limit on changes between Committee meetings in System Account holdings of U.S. government and federal agency securities specified in paragraph 1(a) of the authorization for domestic open market operations, effective May 10 for the period ending with the close of business on May 24, 1983.

Votes for this action:
Messrs. Volcker, Gramley, Guffey,
Keehn, Martin, Morris, Partee,
Rice, Roberts, Mrs. Teeters,
Messrs. Wallich, and Timlen.
Votes against this action: None.
(Mr. Timlen voted as alternate for
Mr. Solomon.)

This action was taken on recommendation of the Manager for Domestic Operations. The Manager had advised that since the March meeting, large net purchases of securities had been undertaken to meet reserve needs due to increases in currency in circulation and required reserves, reducing the leeway for further purchases over the intermeeting interval to slightly under $1 billion. It appeared likely that purchases in excess of that leeway would be required over the remainder of the intermeeting period.

4. Agreement with Treasury to warehouse foreign currencies

At its meeting on January 17-18, 1977, the Committee had agreed to a suggestion by the Treasury that the Federal Reserve undertake to "warehouse" foreign currencies--that is, to make spot purchases of foreign currencies from the Exchange Stabilization Fund (ESF) and simultaneously to make forward sales of the same currencies at the same exchange rate to the ESF. Pursuant to that agreement, the Committee had agreed that the Federal Reserve would be prepared to warehouse for the Treasury or for the ESF up to $5 billion of eligible foreign currencies. At this meeting the Committee reaffirmed the agreement on the terms adopted on March 18, 1980, with the understanding that it would be subject to annual review.

Votes for this action:
Messrs. Volcker, Solomon, Gramley,
Guffey, Keehn, Martin, Morris,
Partee, Rice, Roberts, Mrs. Teeters,
and Mr. Wallich. Votes against this
action: None.

## APPENDIX

Questions have been raised about my views on the Federal Reserve's setting and announcing "objectives" for a variety of economic variables. As you know, the FOMC already reports its "projections" or "forecasts" for GNP, inflation, and unemployment. These projections were included with the materials I reported to the Committee last week, as they had been at earlier hearings. I believe the practice of reporting the full range and the "central tendency" of FOMC members' expectations about the economy may be useful in reflecting the general direction of our thinking, as well as suggesting the range of possible outcomes for economic performance in the 12 or 18 months ahead, given our monetary policy decisions and fiscal and other developments over those periods.

There is a sense in which those projections reflect a view as to what outcome would be both feasible and acceptable -- given other policies and factors in the economy; otherwise monetary policy targets would presumably be changed. But I would point out that, like any other forecast, they are imperfect, and actual experience has sometimes been outside the forecast ranges.

Moreover, I believe there are strong reasons why it would be unwise to cite "objectives" for nominal or real GNP rather than "projections" or "assumptions" in these Reports.

The surface appeal of such a proposal is understandable. If a chosen path for GNP over a 6 to 18 month period could be achieved by monetary policy, specific objectives might appear to assist in debating and setting the appropriate course for monetary policy.

Unfortunately, the premise of that approach is not valid -- certainly not in the relatively short run. The Federal Reserve alone cannot achieve within close limits a particular GNP objective -- real or nominal -- it or anyone else would choose. The fact of the matter is monetary policy is not the only force determining aggregate production and income. Large swings in the spending attitudes and behavior of businesses and consumers can affect overall income levels. Fiscal policy plays an important role in determining economic activity. Within the last decade, we also have seen the effects of supply-side shocks, such as from oil price increases, on aggregate levels of activity and prices. In the last six months, even without such shocks, the economy has deviated substantially from most forecasts, and from what might have been set as an objective for the year.

The response might well be "so what" -- it's still better to have something to "shoot at." But encouraging manipulation of the tools of monetary policy to achieve a specified short-run numerical goal could be counterproductive to the longer-term effort. Indeed, we do want a clear idea of what to "shoot at" over time -- sustained, non-inflationary growth. But the channels of influence from our actions -- the purchase or sale of securities in the market or a change in the discount rate -- to final spending totals are complex and indirect, and operate with lags, extending over years. The attempt to "fine tune" over, say, a six-month or yearly period, toward a numerically specific, but necessarily arbitrary, short-term objective could well defeat the longer-term purpose.

Equally dangerous would be any implicit assumption, in specifying an "objective" for GNP, that monetary policy is so powerful it could be relied upon to achieve that objective whatever else happens with respect to fiscal policy or otherwise. Such an impression would be no service to the Congress or to the public at large; at worst, it would work against the hard choices necessary on the budget and other matters, and ultimately undermine confidence in monetary policy itself.

Some of the difficulties could, in principle, be met by specifying numerical "objectives" over a longer period of time. But, experience strongly suggests that the focus will inevitably, in a charged political atmosphere, turn to the short run. The ability of the monetary authorities to take a considered longer view -- which, after all, is a major part of the justification for a central bank insulated from partisan and passing political pressures -- would be threatened. Indeed, in the end, the pressures might be intense to set the short-run "objectives" directly in the political process, with some doubt that that result would give appropriate weight to the longer-run consequences of current policy decisions.

I would remind you that we have paid a high price for permitting inflation to accelerate and become embedded in our thinking and behavior, partly because we often thought we could "buy" a little more growth at the expense of a little inflation. The consequences only became apparent over time, and we do not want to repeat that mistake.

Put another way, decisions on monetary policy should take account of a variety of incoming information on GNP or its components, and give weight to the lagged implications of its actions beyond a short-term forecast horizon. This simply can't be incorporated into annual numerical objectives.

As a practical matter, I would despair of the ability of any Federal Reserve Chairman to obtain a meaningful agreement on a single numerical "objective" among 12 strong-willed members of the FOMC in the short run -- meaningful in the sense of being taken as the anchor for immediate policy decisions. Submerging differences in the outlook in a statistical average would, I fear, be substantially less meaningful than the present approach.

As you know, we adopted this year the approach of indicating the "central tendency" of Committee thinking as well as the full range of opinion. These "estimates" provide, it seems to me, a focus for debate and discussion about policy that, in the end, should be superior to an artificial process of "objective" setting that may obscure, rather than enlighten, the real dilemmas and choices.

Questions have also been raised on the issue of international coordination of monetary policy and whether or not to stabilize exchange rates multilaterally. I can deal with these important issues here only in a most summary way.

Coordination, in the broad sense of working together toward more price stability and sustained growth, is plainly desirable -- indeed it must be the foundation of greater exchange rate and international financial stability in the common interest. But stated so broadly, it is clearly a goal for economic policy as a whole, not just monetary policy.

The appropriate level of interest rates or monetary growth in any country are dependent in part on the posture of other policy instruments and economic conditions specific to that country. For that reason, explicit coordination, interpreted as trying to achieve a common level of, for instance, interest rates or money growth, may be neither practical nor desirable in specific circumstances. What does seem to me desirable -- and essential -- is that monetary (and other) policies here and abroad be conducted with full awareness of the policy posture, and possible reactions, of others, and the international consequences. In present circumstances, we work toward that objective by informal consultations in a variety of forums with our leading trade and financial partners, recently on some occasions with the presence of the Managing Director of the IMF.

As this may imply, I believe a greater degree of exchange market stability is clearly desirable, in the interest of our own economy, but that must rest on the foundation of internal stability. In recent years, in my judgment, the priority has clearly had to lie with measures to achieve that necessary internal stability. In specific situations, particular actions may appear to conflict with the desirability of exchange rate stability; that possibility is increased when the "mix" of fiscal and monetary policy is far from optimal, as I discussed earlier in my statement. Such "conflicts" should diminish as internal stability is more firmly established.

The idea of a more structured international system of exchange rates to enforce greater stability in the international monetary and trading system raises issues far beyond those I can deal with here. I do not believe it would be practical to move toward such a system at the present time, but neither would I dismiss such a possibility over time should we and others maintain progress toward the necessary domestic prerequisites.

### COORDINATION OF FISCAL AND MONETARY POLICY

Mr. VOLCKER. You referred at the start to the fact that there are really two different issues that are involved in the Senate resolution. One is policy itself. I don't address the substantive policy in my statement, but I do address the question of coordination with monetary policy, and I certainly address the question of how we can contribute to appropriate congressional committees and congressional oversight over the Federal Reserve, which I take it is a large part of the concern.

The statement does describe at some length the way we go about formulating policy, which is a matter that Chairman Garn raised in his letter to me, and I think it bears upon some of these points.

I make the point that if you look at long-range economic objectives, I don't think there's any particular dispute. Those long-range objectives are specified in legislation and they are quite natural. We all want to see growth and price stability and high employment, but I do make the point that monetary policy isn't the only thing that affects our ability—either short-term or long-term—to reach those goals. Discussions among the public or even in the Congress sometimes give me the impression that the thought is abroad that the Federal Reserve, by itself, can do all these things. I'm sure that's a misstatement, but I do encounter that impression.

As far as monetary policy is concerned, it's made by a committee of independently appointed people who bring their own analytic views, their own judgments to the table, and they are not always going to agree on just how the economy works or what the outlook is.

The job of the Chairman is to get some agreement on a specific operational decision and the Chairman has to be successful in that job, but I think it's asking to much to expect anybody to mold a consensus or command unanimity about the outlook or on a particular analytic approach to policy. Differences in that area are inherent in the fact that you're working under a committee system. It is unrealistic to ask the Federal Reserve to present an institutional objective, when policy is made by individuals who may not agree in the short run on how to express broad objectives as a particular growth pattern in GNP or a price level or an employment level or whatever.

We, of course, have to take fiscal policy more or less as a given. We do express our policy intentions, as indeed required by law, in terms of monetary and credit aggregates, and we do present in some detail the results of that process and the outlook to the Congress at least semiannually and informally more frequently; we have just gone through that process, as you well know.

As part of that, for some time, we have given you a range of projections about the outlook; more recently we tried to narrow it down, with the so-called central tendency that the majority of the committee members feel is a likely outcome.

I might say, as I indicated in testifying last week, I think inherent in such a forecast is some knowledge of monetary policy and an implicit feeing that the forecast, insofar as monetary policy can affect it, must be broadly acceptable or we would change policy, to the degree that monetary policy can influence it.

In that connection—and this bears upon setting out more short-term objectives—because something happens differently than you expected at the beginning of the year doesn't necessarily imply that policy should be changed. You could, conceivably, have a better result than you anticipated at the beginning of the year; even if you have a worse result it may not be something that you can improve, in terms of the ultimate objectives, by shifting policy. I make that point because I think the crux of policy is trying to look beyond today or next month or next quarter—or even the current year—to the results of your actions over a period of time. Of course, none of that can be really incorporated in a short-term forecast or "objective," or whatever you call it.

Let me return to the question of coordinating fiscal and monetary policy. Coordination is a word upon which I'm sure the U.S. Senate and the U.S. Congress would vote unanimously: more coordination is always better than less. But when you get to the details, when you get to the specifics, there's a question about what you mean by coordination.

If the Congress and the administration, let's say, greatly increased the deficit, what's the implication of that? More rapid monetary growth, because we should accommodate the deficit, and let inflation go? Or should we try to offset it in some sense by less rapid monetary growth? I think we've all heard the answer is "coordination," but that doesn't respond to the question of what policy should be, which I think depends upon the circumstances. You could ask the reverse, what would be an appropriate response to a reduction in deficit?

The point I'm making is I don't think there's any simple or automatic tradeoff between fiscal actions and monetary policy actions. A budgetary decision inevitably will affect the distribution of the available supply of credit in the economy and is going to affect interest rates. It will affect the mix of consumption and investment.

But monetary policy can't automatically offset those distributional or market effects of fiscal policy, whatever it does.

I interpret your interest in coordination as seeking a way, as part of your oversight function, as part of your fiscal policy responsibilities, of elucidating the choices involved in this area. Our reporting framework should, and I think it does, contribute to that necessary elucidation and debate. I'm going to suggest at least one way in which it might be improved.

### FED HAS TO MAKE ASSUMPTIONS

This year—just to make it more concrete—we have set forth a growth range for total debt in the economy that we think is consistent with the objectives we want to achieve over time, consistent with the monetary targets. It occurs to me that it may be of some help to the Congress, if in your deliberations on the budget, we build on that a bit, amplify the discussion to include the implications of the budget outlook or—depending upon the state of your deliberations—alternative budgetary outlooks on the distribution of debt between the private and governmental sectors and the potential credit market pressures.

These are things I've often touched upon in my own testimony, but I think they could be more directly noted and analyzed in our report itself; that is, the question of the implications or risks with respect to the availability of credit to the mortgage market, the bond market, or the loan markets.

I don't want to suggest that this is an area where one can be at all precise, because many other factors, including, for instance, the inflation outlook and the growth of the economy itself, impinge upon credit flows and interest rates. I also believe very strongly that the central bank should not try to involve itself in the highly uncertain business of forecasting interest rates. But I do think this is an area where our reports might usefully be amplified somewhat.

As to the immediate question of what the Federal Reserve is looking at in terms of the assumptions underlying the budget resolution, I think you will find, in our midyear report, that our assumptions aren't really greatly different from those contained in the budget resolution, although I must say that in analyzing the budget outlook we assume, rightly or wrongly, that some of the savings and some of the revenue actions called for in the resolution might not be achieved. I could make the same general statement about the administration forecasts. They are broadly consistent with the ones that we set out, and I have to repeat again that to the extent there is an understandable concern about lower interest rates, it would be enormously helpful—from that viewpoint and from many other viewpoints—that still stronger action be taken against the deficit than is implied in the budget resolution.

Certainly we have not felt that it's appropriate, in the present circumstances, to raise our monetary targets because the budget deficit was going to be bigger than the budgetary resolution implied because we think the potential of that action for more inflation and for higher interest rates would be entirely counterproductive. In the statement I do discuss more directly the question of targeting the GNP or some portion of the GNP, either nominal or real, and the inflation rate, as a target or as an objective rather than as a projection, or a forecast or an assumption. That may sound like a semantic difference, but I don't think it is.

I have attached an appendix that I attached to my statement last week. I do think there is a real danger that stating these as objectives would turn attention away from the role of other public and private policies affecting economic activity and prices, that it would implicitly promise more than could be delivered, and that it would risk concentration on short-term and not readily controllable results at the expense of continuing long-range objectives. And I think there are lessons in history in that connection.

We have to make assumptions, but I don't think we should deify them as objectives, particularly when the actuality may turn out to be better than the assumption made at the beginning of the year, which is likely to be the case this year, for example. We would not have been so bold, I suppose, as to propose as an objective economic growth as rapid as we are getting now. That doesn't say that it's bad, but, just because we said it was an objective to have rapid growth at the beginning of the year, I don't think we should necessarily take the policy for that reason, which is what citing it as an objective may have implied.

Those are the basic points that I make in my statement. I might just add one other point, Mr. Chairman.

I listened to Senator Moynihan. I don't want to raise all the questions he's raised—although I'd be glad to deal with them—but he did put it as an issue of who controls monetary policy. I assume, in an institutional sense, that ultimately, obviously the Congress does, but it's delegated to us. I don't deal with that question here, but our view on that would be very strong so I don't have to recite it here.

Senator Moynihan gave me permission to amend his statement, if I may, to say that certainly the institutional arrangements in Germany are very much parallel to our own——

Senator GORTON. Senator Moynihan authorized me to correct the record in the same fashion, Mr. Chairman.

Mr. VOLCKER. I would go further and say his statement was a little too sweeping in that there are many other countries, too. That is a basic institutional issue, of course, which I don't deal with in this statement but I'm well prepared, I hope, to defend the present relationships.

### THERE IS NO EASY SOLUTION TO INFLATION

Senator GORTON. Mr. Chairman, in the fascinating hearing before this committee at which you led off the testimony a week or so ago, late during that hearing Professor Blinder from Princeton took a minority point of view. In a way, I guess he tempted all of us by saying that there was an easy way out. The thrust of his testimony was that there was so much unused capacity in our economy at the present time that we could well afford for a period of some 2 years a relatively expansionary monetary policy, more expansionary than that which has been approved by the Federal Reserve Board, with great risk of inflation and with a much greater possibility of causing real growth in the economy of 6 percent or more for perhaps 2 calendar years.

I wonder if you could comment on the risks which might be inherent in following that advice.

Mr. **Volcker**. The first comment I would make, I guess, is to beware of easy solutions, or be wary of them anyway.

The economy, obviously, has some considerable potential to grow during this period and has been growing fairly rapidly, but the kind of question you raised is precisely the kind of question that gives great debate around the table of the Open Market Committee.

I think, myself that historically that kind of reasoning has often led the Federal Reserve in the past to be too easy, precisely at this stage in the cycle, in the thought that the economy has lots of room to grow and nothing much can go wrong now. You begin setting in motion forces that are not necessarily present today, but that can be stirred up today to come back and bite you next year or the following year.

It is terribly important that we build upon this progress that we have made against inflation and retain a healthy sense of caution about actions that might lead to a revival of inflation in the future.

There's a great deal of skepticism on that point in the marketplace and among the American population now, as you know, given history. If you take the view, as certainly I do, that the prospects for a long, sustained recovery depend upon a sense of having inflation under control, a sense of stability, then you have got to be cautious.

What does that mean concretely? I can only answer by saying, of course, that many people say our policy has been inflationary recently. We debated that point in recent meetings. We arrived at the conclusion, given to you last week that some restraining action or less accommodative policy was appropriate at this stage, taking account of the growth of liquidity, the growth of money, the degree of momentum in the economy. Taking all those things into account, we reached the judgment to take the modest steps that we did take over the last couple of months.

Senator **Gorton**. The risk of Professor Blinder's proposal, therefore, I guess, is there's a serious risk of inflation and a kind of cycle through which we went in 1980, 1981, and 1982.

Mr. **Volcker**. Yes, if what he is saying, by implication, is that we should have an easier monetary policy now, we obviously disagree with him or we would have arrived at that conclusion ourselves. I'm not sure that's what he was saying or whether he was looking to the future. I haven't read his testimony.

Yes, we certainly do keep an eye out for the future inflationary potential of what we are doing now, not just in the interest of keeping inflation under control, but also because we think that's fundamental for a sustained economic growth.

Senator **Gorton**. In an intriguing and perhaps offhand note in your written testimony at page 5, you have the remark that many would argue the undesirability as well as the impracticality of controlling monetary growth precisely.

The impracticality is obvious, but it nonetheless seems that if it were possible to control monetary growth precisely that it would be desirable.

Why do you characterize increased control of monetary growth as undesirable?

Mr. **Volcker**. That issue gets debated. I suppose that phrase reflects my sensitivity to the debate that issue gets within and outside the Federal Reserve.

If you take the view that, in the technical jargon, the demand for money changes—and as a theoretical proposition everybody would agree with this—if you really knew money demand was changing or velocity was changing over a period of time, you would want to accommodate that. You reach precisely the policy objective you had in mind in setting a monetary target. If you had a firm conclusion that the relationship between money and the economy was changing you would want to change the target.

There are those who say "Set a single target, hold right to it; so you're more likely to be deluded into thinking you see a change when it isn't permanent; so let's stick to the target through thick and thin." That's one view.

The other view is, "No, these changes are not all that infrequent; you can afford a certain amount of elasticity even when you're not sure; forgetting about the technical problem of actually reaching the target, it's only sensible for that reason to allow a little play, a little cushion. It's not going to do you any damage in the long run and it's going to make things much smoother in the short run."

To put the point rather precisely, if you held money growth precisely to the trend and made no allowance for anything else going on in the economy and the financial markets, refused to acknowledge anything was going on, you would get a very strong volatility in interest rates.

You've got a tradeoff between how much volatility in interest rates you want and how much play you want to leave in the money supply.

### STABILIZATION AND INTERVENTION ON VALUE OF DOLLAR

Senator **Gorton**. In an appendix to your testimony you touched on the issue of exchange rate stabilization but note that the issues involved are so complex as to permit only a summary comment.

Nevertheless, I think it might be appropriate to pursue the question. We all know that capital inflows in response to our high interest rates are keeping the value of the dollar high and making it difficult for American producers to compete in world markets.

What do you see to be the problems or the obstacles in the way of Federal Reserve Board intervention to try to bring the value of the dollar down at least temporarily? Is it possible? Is it desirable? Or what influence would the Board have over that?

Mr. **Volcker**. I think it is possible to do some intervention from time to time, but I think you ought to approach it rather cautiously. I think intervention is a limited tool; there may be specific instances in which it is useful, and I would be prepared to intervene when judgment led one to that conclusion.

There is a danger of putting more weight on intervention than the instrument can bear. If you don't do anything else but intervene in the markets, in some circumstances that may be helpful; in other circumstances the markets are so big that it could even be counterproductive. If they're suspicious about your motives, your intervention is going to be relatively small compared to the totality of money going through those markets.

To put it another way, if you're going to affect the exchange rate, you'd better be prepared to do something more fundamental than intervention alone. Intervention will be most useful when it is moving in a way clearly consistent with other policy measures. It gives an additional message. It works in the same direction. If it is supportive of basic policy, then I think the chances of its being helpful are good. If it's running in conflict with other basic measures, the market will overwhelm any impact.

The worst result would be if you thought you could avoid the basic measures that might be needed by using this tool of intervention so you delay doing other things that should be done.

There are pluses and minuses, but I think intervention can sometimes have a useful subsidiary role.

Senator GORTON. Following up on that question, I'd like to ask you a question which was presented both to Martin Feldstein and Secretary Sprinkel last week.

Do you have any estimates of the sensitivity of the value of the dollar to, say, one or two point fluctuations in interest rates above or below their current level, either that you can give us right now or that the Board could submit to us?

Mr. VOLCKER. I can't give you any right now. I could probably give you the results of some econometric investigations of that subject, but I would do it with some hesitancy, only because what we do know is that estimates made on that basis are not very accurate; in particular circumstances it seems to affect the market quite differently depending upon, I suppose, the set of expectations, what else is going on in the current account or whatever.

Right now the dollar is, I suppose, on the average, as high and maybe higher than it was a year ago or 18 months ago. Interest rate differentials with other countries are quite different than they were 18 months ago. You have had a number of occasions in the past couple of years which—just looking directly at interest rates and exchange rates, just taking those two variables—don't make any sense against the common assumption, which has some justification, that higher interest rates mean a higher exchange rate or conversely.

We can give you some theoretical or econometric analysis, but take it with a healthy grain of salt.

One would readily agree, all other things being equal, that one would ordinarily expect that an increase in the interest rate differential is going to strengthen the dollar or conversely.

[Chairman Volcker subsequently submitted the following information for inclusion in the record of the hearing:]

## Estimates of Effects of Interest Rates on Exchange Rates

The quantitative evidence on the relationship between interest rates and exchange rates should be interpreted with care. Two important points should be made at the outset. First, econometric estimates of coefficients relating interest rates and exchange rates vary a great deal depending on the period studied and, furthermore, the estimates derived from the data for any given period are not very precise in statistical terms. Second, changes in interest rates may occur in response to a variety of factors and consequently the effects on exchange rates associated with a given change in interest rates may vary substantially. For example, a decrease in the fiscal deficit, holding the money supply constant, normally would be expected to lower interest rates and also to lead to a decline in the foreign exchange value of the dollar. Similarly, an increase in the growth rate of the U.S. money supply also would normally be expected to depress both interest rates and the dollar in the short run. However, higher inflation from the monetary expansion could lead to subsequent increases in interest rates and the dollar might depreciate further to compensate for the higher U.S. inflation.

Research on the relationship between interest rates and exchange rates by the staff of the Federal Reserve Board has been conducted along two lines. The first exploits single-equation models of exchange rates, the second makes use of a large structural econometric model.

The single-equation studies use regression analysis to explain movements in the weighted-average foreign exchange value of the dollar with several variables including interest rates and inflation rates.[1] A variety of similar equations have been estimated over various time periods. In sum, they suggest that the effect of reducing U.S. short-term interest rates by one percentage point, holding all other factors constant, ranges from a depreciation as small as 0.1 percent to a depreciation as large as almost 4 percent. The size of the coefficient relating interest rates to exchange rates (and its statistical significance) varies with the period analyzed, the frequency of the data, and with the particular specification of the equation estimated.

An alternative method of analyzing the effects of interest rates on exchange rates has been to use the large-scale Multi-Country Model (MCM) developed by the Federal Reserve Board staff. The MCM includes a model of the U.S. economy as well as models of four of its most important trading partners: Canada, Germany, Japan and the United Kingdom. In the MCM both interest rates and exchange rates are simultaneously determined by the structure of the model, responding to changes in economic policies, as well as to changes in other factors such as investors' portfolio preferences. The strength of an approach such as that of the MCM is that such models have fully articulated structures and can allow for interest rates and exchange rates to be affected in several different ways. Furthermore, this type of approach allows for the interaction both within and among economies in the form of "feedback"

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1/ The "exchange rate" in these studies is a weighted average of bilateral exchange rates for the dollar against the G-10 countries and Switzerland. The weights are multilateral shares of total trade.

effects. The potential drawback of the MCM, indeed of any model, is that simulation results are dependent on the particular model being a reasonably accurate representation of the economy in terms of both the structure specified and the coefficients of the equations. Financial sectors of international models have always proved particularly difficult to construct. The simulations discussed below are subject to these qualifications, since they take the MCM's structure, which at best reflects normal relationships, as appropriate for the analysis of a specific question in specific circumstances. In simulations with the MCM, the historical responses of exchange rates to the induced changes in interest rates are attributable solely to the initial change imposed on the model that, in turn, works through the specific structure of the model.

In the MCM, a reduction in U.S. government expenditures leads to a decrease in short-term U.S. interest rates as well as a depreciation of the dollar. After four quarters, a decline of one percentage point in U.S. short-term interest rates resulting from such a fiscal action is associated with about a 1/4 percent depreciation of the dollar and after eight quarters with a one percent depreciation.2/ It should be noted that the longer the simulation is continued, the more the results are affected by the multiple interactions in the model.

In the MCM, an increase in the growth rate of the U.S. monetary aggregates also causes U.S. interest rates to fall and the dollar to depreciate, but a monetary expansion has different effects elsewhere in

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2/ The depreciation of the dollar is against a multilateral, trade-weighted average of the currencies of the other four countries in the MCM, but since these are the major currencies in the 10-country average described in footnote 1, the results are roughly comparable.

the economy--on output, inflation and the current account. Because of these different effects, a one percentage-point decline in U.S. short-term interest rates resulting from a faster expansion of the money stock is associated with 3/4 percent depreciation of the dollar after four quarters of simulation and 1.6 percent after eight quarters. A part of this depreciation in effect compensates for the higher inflation rate induced by the more expansionary monetary policy.

These two simulations show that, depending on the source of the initial change in interest rates, exchange rates may move either more or less than in proportion to the change in interest rates. In other simulations movements in interest and exchange rates need not even be positively related. For example, a simulation in the MCM of an autonomous shift by private wealth holders out of financial assets denominated in foreign currencies and into assets denominated in U.S. dollars produces a decline in U.S. interest rates and the dollar appreciates.

This brief discussion of research and analysis undertaken at the Federal Reserve Board underlines two important propositions to keep in mind when analyzing the effects of changes in interest rates on exchange rates. First, the simple correlation between the two is not all that precise. The studies using single-equations clearly demonstrate this point. Second, in more elaborate models it is crucial to specify the original source of any interest rate movement. The results of simulations with the MCM show that even if one (unrealistically) assumes that the structural relationships are known with certainty, the relationship between changes in interest rates and changes in exchange rates is not simple and cannot be captured in a single figure.

Senator GORTON. Thank you. At this point I will defer to Senator Heinz.

Senator HEINZ. Thank you very much.

### OPENING STATEMENT OF SENATOR HEINZ

The requirement contained within the budget resolution that Congress examine the relationship between monetary policy, fiscal and budgetary policy, and the economy provides a confrontation of introspection that is long overdue.

Those who have looked to monetary policy to find the root of our economic evils would do well to remember the Biblical quotation from the Book of Matthew: "And why beholdest thou the mote that is in thy brother's eye, but considerest not the beam that is in thine own eye?"

For decades Congress has avoided taking responsibility for the effect of big spending budgets on interest rates, employment, and economic growth by making a scapegoat out of the Federal Reserve Board.

Mind you, I am not absolving the Fed of what I believe have been past excesses of rapid stop-go fluctuation in money growth. While the Fed can, and recently has, contributed to lowering inflation and interest rates, it can and has in times exacerbated the already dangerous situation caused by runaway Federal spending. As I said in my statement at your confirmation hearing, my respect for you comes from my belief that you have learned many lessons during your many years as Chairman of the Fed, and have adopted a more moderate long/term strategy. It is my hope, and my greatest concern that you, Mr. Volcker, not return to past patterns of dramatic short-term reversals of policy under the guise of fine tuning.

In recent weeks the financial markets have probed everywhere for indications of future Fed policy and have hung on your every word. I would think that what we do in this committee with the resolution we are required to report will be more important than anything that has come before. Indeed this quiet little provision in the budget resolution may be more important than the budget itself. It will allow Congress, in the simplist terms, to vote on whether it will acknowledge that the control over the economy rests upon control over levels of Federal spending as a percentage of GNP or whether Congress will continue to avoid the harsh decisions of budgetary triage and continue to scapegoat the Fed.

Mr. Chairman, welcome back. I think you have probably seen enough of the Senate Banking Committee in the last week or two.

#### FED HAS TAKEN CAUTIOUS APPROACH TO CHANGES

I would just like to observe that there are an awful lot of people who do look to monetary policy to be the rescuer of the economy. And since for decades Congress has avoided taking responsibility for the big budget deficits and their effect on interest rates and on employment and on economic growth, they have tended to make a scapegoat out of the Federal Reserve System and it rather reminds of the seventh chapter, third verse of Matthew, which is, "And why beholdest thou the mote that is in thy brother's eye, but considerest not the beam that is in thine own eye?"

I wouldn't want you to think that the lack of Congress looking at itself in the mirror—and I'm sorry to say that seems to be a failing regardless of what the nature is of one's party affiliation—does not, in my judgment necessarily absolve the Fed of what I have told you on previous occasions I believe to be excesses of rapid stop and go fluctuation in the money growth.

I do think, as I said at your confirmation hearings, that you and the Board of Governors have learned from past mistakes and, in my judgment, you have adopted a very different monetary policy than we had in 1979, 1980, and 1981.

If you look at the fluctuations, particularly in $M_1$, but they're not absent from $M_2$ on a quarterly basis, annualized quarterly basis, there is tremendous volatility and fluctuation in those aggregates, especially in $M_1$.

It is sometimes argued that those numbers are not adjusted for the latest kind of instruments that now get counted in $M_1$, NOW accounts and so forth, but, unfortunately, there is still so much volatility in those historical numbers that I don't find that a credible assertion. Even if it were on its face true, one would have to believe that the market, if it understood that to be true, would not have reacted with the kind of volatility that it did react where interest rates were involved.

I give you that lengthy preface because my question is really this. Would you agree that the Fed has embarked on a course of action where it has learned not to try within a very short space of time—let us say where it has discovered that the growth range has been overshot—to try within a very short range of time to correct that within a matter of a short period by tightening up? Would you agree that the Fed has in a sense made more cautious policy in that regard?

Mr. VOLCKER. I think we have had a more cautious policy in that regard in the past year or more, yes, but I would put that in the right setting.

Senator HEINZ. I would agree, by the way, with that timeframe. I think it's been over the last 12 months.

Mr. VOLCKER. You referred to a basic change in policy. We're really getting into semantics—pure semantics, I guess. I would argue that our basic policy objectives and general approach have not changed.

What has changed is that we have quite different economic circumstances, quite different in two respects. For the obvious reason that we had a recession, inflation is way down. While there's still a lot of skepticism about inflation, people feel much better about it than they did before. There isn't the speculative fervor; there isn't the anticipation that there was before. We are in different circumstances in that way.

We also had—I agree with you—institutional changes that explain all these ups and downs in the money supply, but we do have some unusual questions about changes in trends or the cyclical patterns in $M_1$ velocity.

If you take the economic conditions and those questions about the possible shifts in behavior pattern of $M_1$, then yes, under those circumstances, we have indeed been more cautious about moving highly aggressively whenever a figure got off a track that was set earlier, particularly with respect to $M_1$. That is why we de-emphasized it.

Senator HEINZ. Picking the interest rate of your choice, how many basis points within such an interest rate would you attribute to the more or less agreed upon three components of such rates—the basic price of money, so-called supply-demand price, inflation, and the so-called risk premium?

Mr. VOLCKER. I don't think I can give you a statistical answer.

Senator HEINZ. After one does protracted statistical analysis on a subject such as this, then one adjusts it for gut feeling.

Mr. VOLCKER. I don't know how you define the risk premium. Are you thinking of risk as fluctuation in interest rates in the future?

Senator HEINZ. I would define——

Mr. VOLCKER. You're not thinking of the risk premium on a second class company or something?

Senator HEINZ. I'm talking about the basic uncertainty that remains after you deducted the basic price of money—some people have said that's 2 to 3 percent—the inflation rate, and what is left is generally classified as that which is due to uncertainties.

Mr. VOLCKER. I thought you were going to put the Government deficit in there someplace.

Senator HEINZ. Well, there is a little uncertainty. It did occur to me.

Mr. VOLCKER. That can enter in, of course, in two directions, the basic supply and demand, as you term it, and uncertainty.

Senator HEINZ. I might tell you, in this Senator's judgment, that is one of the big factors.

Mr. VOLCKER. Let me attempt an answer which isn't going to be very satisfactory.

### ECONOMIC CONFIDENCE IN UNITED STATES RETURNS

Looking at very short-term rates, they are largely reflecting what I think you had in mind when you said basic supply and demand. People don't, theoretically, have to worry about what the future interest rate is going to be or the future inflation when they're dealing with overnight money. I don't think that's strictly true, but you start from that point.

As you get longer in the maturity spectrum, then I think currently—and this would differ a great deal depending upon the time period you're in—the inflation premium is going to merge into what you're calling the risk premium and is going to be very substantial, but it also reflects the balance of supply and demand.

Senator HEINZ. I guess, to simplify the analysis, I would say take either a 5- or 10-year maturity, subtract what you believe to be the price of money, and today's inflation rate, and attribute the rest to a variety of fears, including the fear of inflation.

Mr. VOLCKER. All right. I can't give you an answer which——

Senator HEINZ. I've got a feeling that this is going to be lengthier than time will allow.

Mr. **Volcker**. I can't give you a good answer, so let me repeat that.

Senator **Heinz**. Let's not.

Mr. **Volcker**. Let me observe that surveys—not necessarily of the general population but of people in financial markets—that ask "what do you think the inflation outlook is?" Tend to be answered, "between 6 and 7 percent." These surveys are asking about 5 years from now and 10 years from now.

When you compare that to the current inflation rate of, say, 3.5 or 4 percent, if you really believe those surveys, I suppose you would say something like 3 percent is that extra inflation premium, because they don't believe the current inflation rate is going to last.

That may be an overestimate, but if you got very literal about applying the results of those surveys, that's the answer you would get.

Senator **Heinz**. Let me get your reaction to a somewhat different point of view. I understand you recently received a letter from several members of the House of Representatives which said, "Almost every other indicator besides $M_1$ fails to support the wisdom of a rise in interest rates. The dollar has risen and remains quite strong against the strongest foreign currencies. The prices of gold and other sensitive commodities have remained stable, if not soft, indicating an absence of speculation on future inflation. The growth of $M_3$ has slowed over the past 8 months at the same time as $M_1$ accelerated, and even $M_1$ shows recent signs of slowing without a rise in the discount rate."

Do you basically agree with that statement?

Mr. **Volcker**. Not entirely. The best answer I can give to that statement is my testimony. I was aware of that letter before I testified and, as I pointed out, during the second half of the second quarter at least, there were other indicators of liquidity, money, credit, rising more rapidly than, let's say, made us entirely comfortable, apart from $M_1$, $M_2$ and $M_3$ growth were on the high side in June, for instance. The credit figure in the second quarter was substantially bigger than the credit figure in the first quarter. And, of course, we are aware of the outlook for the deficit. We are also aware that over the last couple of months certainly—I'm not making a long-range forecast—the economy had assumed a lot of forward momentum. That isn't bad in itself, but your risks looking ahead were more balanced than they had been for some time in terms of the sustainability of the recovery. We were looking at all those factors.

I think the international exchange rate, debt considerations, clearly in the short run were on the other side. You can see in our policy record that they were factors which weighed heavily on our minds in the other direction in terms of the short-term policy decision.

Senator **Heinz**. Is that because everybody else just is in worse shape than we are?

Mr. **Volcker**. From the perspective of the rest of the world—entirely apart from interest rates and all the rest—we look to be in pretty good shape. In relative terms, yes, I agree with what you say. There is a confidence in the United States in the basic business climate, the economic outlook, the political climate relative to other countries. I think those are all big considerations during this period of economic history.

Senator HEINZ. Well, my time has expired. I would just observe that, unless you've been doing something that we didn't know about, the United States has not had to go to the IMF and accept terms of conditionality in return for help in refinancing its debt, although, I must say, that there are times when I wish the United States, for other reasons, would go to the IMF and sign onto a conditionality program because one of the first things they ask you to do is get your domestic budget in order.

At the present rate we're going, it may take the IMF to reduce the budget deficit because, notwithstanding the heroic efforts of my friend, Slade Gorton, and other members of the Budget Committee, we haven't exactly scored a stunning victory in that particular effort.

Mr. Chairman, I thank you for your responses to a variety of questions. To sum up what I hear you saying is that we can expect a properly cautious management of the aggregates by the Federal Reserve System, that to the extent that we have interest rate pressures and threats to the economic recovery they come about because of fears of future inflation fueled by very large deficits, that the reason there is a considerable amount of relaxation of current tension in the interest rates markets is largely because of short-term factors and not the least of which is our economy if you look at others around the world looks good when you look hard at them, and that, as a consequence, I would extrapolate from that, for the purposes particularly for which we're holding the hearing, that there is likely to be a period of reasonable stability in interest rates, reasonable stability in economic recovery, but that we cannot necessarily count on that lasting indefinitely, and that the Congress would, therefore, be well-advised to look beyond this particular fall or next spring when the swallows will be coming back to Capistrano.

## CONGRESSIONAL BUDGET RESOLUTION IS HELPFUL

Mr. VOLCKER. Let me just add to that last comment of yours that I think there has been a feeling, if I interpret it correctly, in the Congress and maybe elsewhere, that this budgetary problem that we all face has a fuse for 1985: I could imagine circumstances in which that might be true, with rather slow growth of the economy, not too much housing—a positive growth, but a rather subnormal recovery.

I don't think that's true at all if you have a more rapid recovery, which everybody would like to have. Then I think that fuse becomes much shorter. You have some intimations of it in the market now. That's partly what went on in the second quarter and coming into the third quarter. We have had a sizable increase—not massive, but noticeable—in private credit demands entirely in the consumer and mortgage area. We have had a continuing high budget deficit, and the faster the economy grows, the more consumer and mortgage demands you have. You will have business demands added to them. If the budget problem isn't addressed during that period you've got a problem.

Senator HEINZ. You're saying that an apparent smooth road doesn't mean you can't run headon into a truck coming the other way and the chances are enhanced if you're going too fast?

Mr. VOLCKER. That's right. I think you can even see the truck. It's not just speculation that there might be a truck. The truck is there. It's visible. It's only a question of how far away it is.

[Laughter.]

Senator HEINZ. My analogy—Senator Gorton hasn't yet recovered—stands fine-tuned. Thank you, Mr. Chairman.

Senator GORTON. You have stated that to a certain degree you've used the budget resolution as an indicator, though far from a perfect indicator of where fiscal policy is going.

From your point of view, would it improve the budget resolution for these purposes if it also contained a more complete accounting for control of the Federal credit activities?

Mr. VOLCKER. Yes, if that's feasible. It's one other area of uncertainty, so to speak.

Senator GORTON. And for that matter, all activities?

Mr. VOLCKER. Yes. I certainly would approve of general control of the government finances. It depends upon their credit activity. Those financed through the Treasury, you might consider, do not much substitute for market credit.

I think this is a distinction from the general traditional kind of guarantee programs, like an FHA mortgage. I would certainly not look at guaranteed mortgages in their totality as an additional demand on the credit markets. Much of that would occur anyway through the conventional market.

But particularly if you focus on those Federal programs, with heavy subsidies, directly financed through the Treasury, they are very much like——

Senator GORTON. Let me broaden the question. Looking at the question procedurally as opposed to the substance of the budget, do you have other suggestions for ways in which the budget process leading to a budget resolution could be helpful to the Federal Reserve Board in its formulation of monetary policy?

Mr. VOLCKER. In a procedural sense, the procedures the Congressional Budget Office goes through when making forecasts, putting their budgetary figures in economic perspective, is helpful. The passage of the budget resolution itself is already helpful because it provides a focus for the overall budgetary result that was lacking earlier.

That procedure is far from perfect in achieving its result, as you well know, but I don't think I'd have any particular procedural suggestions. I sometimes wonder these days, in watching the inherently very difficult budgetary process in the Congress, whether the day isn't coming when we ought to go on a 2-year budget cycle.

Senator GORTON. Thank you.

## MUST MAINTAIN BALANCE BETWEEN INTEREST AND INFLATION

Now I'm going to interject with a question from Senator Tower which goes to the concern which you shared with me before the hearing started today and ask you for your public comment on it.

Many analysts suggest that the LDC debt situation has increased the risk premium contained in interest rates. Would congressional failure to pass the IMF bill increase the financial risks and therefore, in your view, put some upward pressure on interest rates?

Mr. VOLCKER. I have no doubt that it would be perceived to increase the financial risks, even though it's not going to affect funding in the short run. This money is for next year and beyond. There's no question in my mind that it would be perceived to increase those risks and, compared to what otherwise would happen, have the result your question implies.

Senator GORTON. One last summary question on a subject on which you've already testified to a degree, but one last clear question.

You make the obvious assumption that as you attempt to steer monetary policy you have two risks on either side. One is reigniting inflationary expectations and thus inflation itself. The other is the unnecessary driving up of short-term interest rates.

Obviously, miscalculation in either direction imposes some costs on the economy.

In which of those directions do you perceive that the costs are greater at the present time and, by implication, which danger occupies at this time and in general a more prominent place in your thinking?

Mr. VOLCKER. In a sense, I agree that those are the kinds of risks that have to be balanced.

Let me just say that a factor in my thinking, at least recently, has been the observation that currently the economy has a good deal of momentum which, in my judgment, is not going to be upset or put fundamentally off course by a modest increase in interest rates, even though we start with interest rates that are higher than I think are appropriate or desirable, and may be necessary for the longer-term health of the economy.

Any tightening action that may have been necessary now is also potentially reversible, in my judgment, without the kind of damage you suggest.

In balancing those concerns, we certainly reached the conclusion that a little action now is preferable to the risk of having to take much stronger action later if we didn't take a little action now.

Senator GORTON. Mr. Chairman, I thank you for your courtesy, your clarity, and your counsel.

Mr. VOLCKER. Thank you, Senator.

Senator GORTON. With that, we will allow you to go to further business and the meeting is adjourned.

[Whereupon, at 3:25 p.m., the hearing was adjourned.]

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